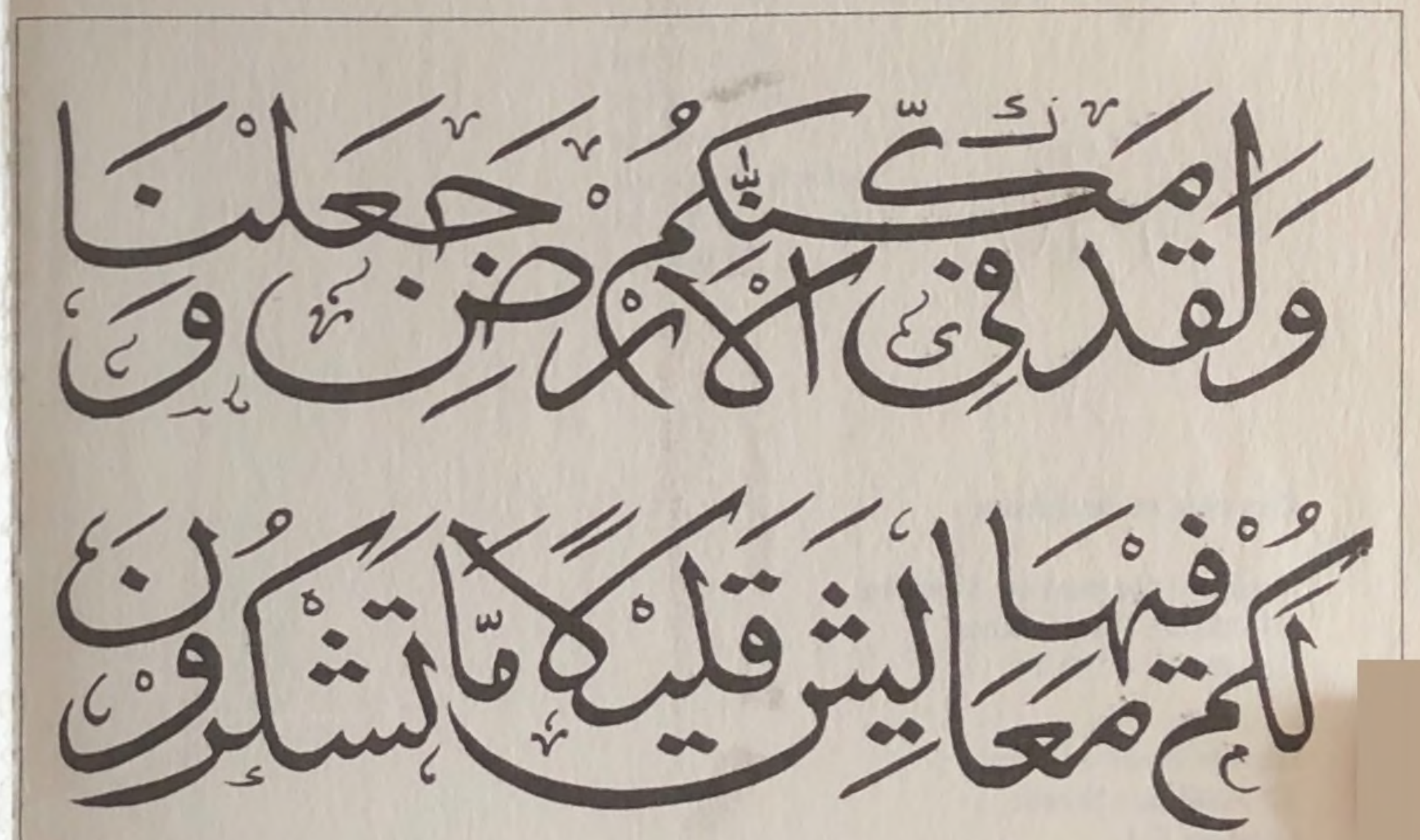
ECONOMIC DOCTRINES OF ISLAM

Banking and Insurance

VOL. 4



AFZALUR RAHMAN

To

My Companion,
My Joy,
My Comfort,
My Pleasure,
My Peace,
My Contentment,
My Life,
My Wife!

Sponsor's Note

We have great pleasure in presenting our third publication 'Banking and Insurance in Islam' to the readers. We have every hope that our readers will patronise this publication as well.

This book is written with new emphasis and new approach to the subject and many of the delicate problems of banking and insurance facing the Millet-i-Islamia are very frankly and plainly discussed in it from the Islamic viewpoint.

It is satisfying to note that the author of this book has tried to find the solution of our banking and insurance problems in the light of the Qur'an and Sunnah of the Holy Prophet (PBUH).

London
20 September, 1979

Salem Azzam
Secretary-General

PREFACE

In the name of Allah, Most Gracious, Most Merciful.

"And whatsoever you have been given is a comfort of the life of the world and an adornment thereof; and that which is with Allah is better and more lasting. Have you then no sense (and understanding)?

Al-Hamdulillah, the fourth volume of the Economic Doctrines of Islam, Banking and Insurance, is now ready for the readers. I hope they will find in it many useful and practical suggestions on banking and insurance in the light of the Qur'an and Sunnah of the Holy Prophet (PBUH).

Inshallah all problems regarding Monetary System and Public Finance will be dealt with in the fifth volume of this book.

London
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وَإِذَآ أَرَدْنَآ أَنْ نُّهْلِكَ قَرْيَةً أَمَرْنَا مُتْرَفِيهَا فَفَسَقُوا۟
فِيهَا فَحَقَّ عَلَيْهَا ٱلْقَوْلُ فَدَمَّرْنَٰهَا تَدْمِيرًا

SECTION ONE

INTRODUCTION

1

GENERAL INTRODUCTION

Islam is a very practical religion and contains everything that is good and beneficial to man irrespective of time, place or the stage of his cultural, social and technological development. It guides us towards a perfect way of life and is free from the drawbacks of other religions. "Today I have perfected your religion for you and completed My blessing on you and approved Islam as the way of life for you" (***Qur'an***:5:3). In these words the ***Qur'an*** claims that God has provided this religion " with all the essential elements of a permanent way of life which comprises a complete system of thought and practice and civilization and have laid down principles and given detailed instruction for the solution of all human problems. Hence there is no need for you to seek guidance and instructions from any other source.

Its principles and system is based on knowledge, justice, benevolence, goodness and wisdom. " This being so should I seek a judge other than God , whereas He has sent down to you the Book with full details? And the people whom We gave the Book (before you) know that this Book has been sent down to you with Truth from your Lord; so you should not be of those who have doubts. The word of your Lord is perfect in regard to Truth and Justice; there is none who can make any change in His decrees, for He hears everthing and knows everything " (***Qur'an***:6:114–115).(1)

And in ***Surah Al-Nisa***, " God does command you to render back your Trusts into the care of those who are worthy of trust and when you judge between people, judge with justice. Excellent is the counsel that God gives you " (***Qur'an***:4:58).

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1. Abul Ala Maududi:***The Meaning of the Qur'an***,Vol.111.pp.18–19.

It is a way of life which is absolutely free from evil, corruption and injustice and is at the same time selfcorrective and self-preventive of possible evil incursions and degeneration. "God commands Justice, generosity and kind treatment with kith and kin, and forbids indecency, wickedness, injustice and oppression. He admonishes you so that you may learn a lesson.

"Those people who make the Qur'an their guide and their book of law, are favoured with the blessing of Allah and are cured of all their mental, psychological, moral and cultural diseases. On the other hand those wicked people who reject this and turn their back on its guidance in fact, are unjust to themselves. Therefore the Qur'an does not allow them to remain even in that bad condition in which they were before its revelation or its knowledge but involves them in a greater loss than before. This is because before the revelation of the Qur'an or their acquaintance with it, they suffered from ignorance alone but when the Qur'an came before them and made distinct the difference between Truth and falsehood, no excuse was left with them to remain in their previous condition of ignorance. After this, if they reject its guidance and persist in their deviation, it is a clear proof that they are not ignorant but workers of iniquity and worshippers of falsehood, which are averse to the Truth. Therefore they themselves are in that case fully responsible for their deviation and whatever crimes they commit after that, shall incur their full punishment. It is obvious that the consequent loss of wickedness must be far greater than the loss of ignorance. The Holy Prophet has summed this up in this concise and comprehensive sentence: "The Qur'an is either an argument in your favour or against you (2).

The Qur'an is sent for all mankind to benefit them in their various field of activities: "O Mankind! This messenger has come to you with the Truth from your Lord, so believe in him for it will be better for you. But if you reject Faith, you should know that all that is in the heavens and the earth belongs to God. " (4:170) And as such it could not survive for all times unless it was comprehensive enough to meet the multifarious needs of the changing cultures, habits, way of life and social and technological demands of the various peoples:

Furthermore as Islam is a religion of man it protects his person, interests and property and provides all the necessary elements that are conductive to his personal and social welfare and safety of his person and property: "And fight them on until there is no more mischief (and oppression) and the way of life

2. Abul Ala Maududi, ***The meaning of the Qur'an*** vol-vi: p : 163.

prescribed by God is established in its entirety" (***Qur'an:8:39***). The word ***'(fitnah)'*** denotes that condition of society which is not safe and free for adoption of the way of Allah. That is why the Muslims have been exhorted to continue the fight to change this state of affairs and to restore peace and freedom for the way of Allah. 'The Arabic word ***'Din'*** which has been traslated here into 'way' originally means,'submission' and is technically used for that way of life which is built on the sovereignty of someone whose commands and regulations are to be followed. Therefore that condition of society in which there is the rule of man over man and in which it is not possible for anyone to follow the Way of Allah is ***'fitnah'***. The aim of Islam in war is to abolish ***'fitnah'*** and establish Allah's way so as to enable people to live as servants of Allah in accordance with the Divine Law.(3)

And to enable man to live peacefully according to the Divine Law, God has appointed its boundaries (hudud), to protect the interests of all people. All the believers are commanded to honour, obey and safeguard these boundaries ***(hudud)***) so that people,persons, interests and properties are protected and they are able to live in peace and prosperity: "It is not fitting for a believer, man or woman, when a matter has been decided by God and His Messenger to have any option about their decision. If any one disobeys God and His Messenger, he is indeed on a clearly wrong path. (Qur'an : 33:36). It is obligatory upon the believers that they must not put their own wisdom in competition with God's Wisdom. "God's decree is often known to us by the logic of facts. We must accept it loyally, and do the best we can to help in our own way to carry it out. We must make our will consonant to the universal Will (of God). (4)

Prophet Muhammad was commanded to establish the Divine Law on the earth: "Then, O Muhammad, We have sent this Book to you which has brought the Truth;---------Therefore you should judge between the people by the Law sent down by God and Do not follow their desires by turning aside from the Truth that has come to you (Qur'an:5: 48-50). Likewise Prophets before him were given the same commandment: "O David ! We did indeed make you a vicegerent on earth; so judge you between men with Truth and justice; and not follow the lusts (of your heart) for they will mislead you from the path of God. There is a grievous penalty for these who wander astray from the path of God." (38:26).

3. Abul Ala Maududi, ***The Meaning of the Qur'an,*** Vol. 1. p: 147.
4. A. Yusuf Ali, ***The Holy Qur'an:*** p. 1117.

The righteous follow the guidance of God's Prophets and it is only the unjust and unbelievers who break the boundaries (*'hudud'*) of God and follow in the footsteps of their lusts and the Satan : " Those who do not believe in God nor in the Last Day; who do not make unlawful that which God and His Messenger have made unlawful, and do not adopt the Right Way as their way (*Qur'an*:9:29). And in *Surah Al-Nisa:* " O Prophet, have you not marked those who profess to believe in the Book that has been sent down to you and in the Books that had been sent down before you, and yet want to turn to the Devil (*'taghut'*) for the judgement of their cases though they have been bidden to reject the devil (*'taghut'*)?. Satan intends to lead them far astray from the right path (*Qur'an*:4:60).

" In this verse, *'taghut'* stands for the authority that make decisions in accordance with laws other than Divine. It also implies that system of judiciary which acknowledges neither *Allah* as the supreme sovereign nor His Book as the final authority. Hence, this verse clearly shows that it is against the demand's of one's faith to take one's case for decision to a law court which by its nature is that of *'taghut'*. Belief in *Allah* and His Book makes it obligatory on the believer that he should refuse to acknowledge such a court as lawful." (5)

Man will always face new situations and new problems in life that will test his faith by tempting him to deviate from the Right path and follow in the footsteps of the Devil. He will wander around in amazament and confusion in the ways of the Devil until he finds the true solution in the Book of God which is in fact a panacea for all his ills and problems. The true believers in all there new situations refer the matter to God and His Messenger to find the correct solution to their problems instead of depending upon their own judgement or judgement of the *Satan*: " If they had referred it to the Messenger or to those charged with authority among them, the proper investigatores would have tested it from them (4:83)". Again in the same *Surah;* " O Believers obey God and obey the Messenger and those entrusted with authority from among you. Then if there arises any dispute about anything, refer it to God and the Messenger, if you truly believe in God and the last Day. This is the only right way and will be best in regard to the end" (4:59).

" This verse is the bases of the whole religious, cultural and political system of Islam and is the first and foremost article of the constitution of an Islamic state. The following fundamental principles have been permanently laid down in it. (1) In the Islamic system, *Allah* Who is the real Authority must be obeyed. A Muslim is first of all the servant of *Allah*; all his other capacities come after this. Therefore, a Muslims as an individual and the Muslims as a community owe their first loyalty to *Allah* and they must subordinate all other loyalties to this, for they are called upon to give their first allegiance to *Allah* . (2) The second fundamental principle of Islamic system is allegiance and obedience to the Holy Prophet. This obedience is not inherent in Prophethood but is the only practical shape of obedience to *Allah*. A Messenger is to be obeyed because he is the only anthentic means through which we can receive commandments and instructions from *Allah*. Hence we can obey *Allah* only by obeying His Messenger, for no other way of obedience is genuine. A tradition explains the same thing " who so obeys me, he obeys *Allah* and whoever disobeys me, he disobeys *Allah*." (6)

(3) " After the first and second allegiance the Muslims owe allegiance to those invested with authority from among themselves. It is obligatory on a Muslim to listen to and obey orders of those invested with authority, whether he likes it or dislikes it, provided that it is not sinful. " Obedience to anyone in a sinful thing is forbidden. Obedience is obligatory only in right things (*Muslim Bukhari).*" (4) The fourth thing that has been established as an absolute and permanent principle is that the Commandment of Allah and the *Sunnah* of His Messenger are the fundamentals of law and the final authority in the Islamic system. Hence if a dispute arises about any matter between any Muslims or between the rulers and the ruled, they should turn to the *Qur'an* and the *Sunnah* for decision and they should, all of them, submit to it."(6)

" What distinguishes a Muslim from a non-Muslim is that the latter claims absolute freedom but the former considers himself to be the servant of *Allah* and uses only that amount of freedom which Islam allows him. The non-Muslims judge all matters in accordance with the rules and regulations made by themselves and do not believe that they stand in need of Divine Guidance. In contrast to this,Muslims, first of all, turn to Allah and His Messenger for guidance about everything and abide by their decision.But if they do not find any commandment therein about anything , only then they are free to act in a manner they consider to be right. The very fact that the Law is silent

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5. Abu Ala Maududi, *The meaning of the Qur'an*, Vol 11:p.137.

6. Abul Ala Maududi: *The meaning of the Qur'an*, Vol.11,pp.132–133.

about a certain thing, is a proof that it allows of action in that particular matter, It should be noted that whenever a community flings the Book of *Allah* and the guidance of His Messenger behind its back and follows such leaders as are disobedient to *Allah* and His messenger, and blindly obeys its rulers and religious leaders without demanding the authority of the Book and the *Sunnah*, it can never escape those evils in which the previous disobedient peoples were involved." (6)

There is no doubt that *Shariah* has clearly laid down its limits of what is permissible *(Halal)* and what is forbidden *(Haram)* and the true believers always decide all their matters and find solution to all their problems and meet all new situations within the prescribed limits of *Shariah*. However, if there is no clear verdict in *Shariah* and a thing (or discipline) is found useful, beneficial and necessary, they adopt it in their system.

Thus there are two codes of conduct and behaviour: one governed by the laws of *Shariah* and the other dictated by the Devil or one's own self *(Nafs)*. The former code of conduct is universal for all times and places and covers all situations and problems and as such no democratic congress, law making process or popularity of any system can ever legalise something which is forbidden, or invalidate something which is allowed by the Islamic *Shariah*. Wisdom of *Shariah* is to provide basic principle without mentioning each and every need, situation or problem, so that people may build their own systems to meet the needs of their own time and place within the guide-lines of *Shariah*.

Whether a system is new or old is not important. What is important is that it must fulfil the rules of *Shariah* and must not contain any of the unlawful elements like interest *(riba)*, gambling *(Qamar)*, deciet or uncetainty *(garar)*, unspecified quantity *(juhala)* etc.Every new problem or situation does not need new principles but has to be judged by the existing laws of *Shariah* whish are everlasting and comprehensive enough to cover these new situations and problems, no matter how much complicated. What is needed is the desire, will and effort on the part of the Muslim community to find the solution within the guide-line of the Divine Revelation.

There are certain fundamental truths which must not be forgotten or ignored while discussing the main principles of Islamic economics. This will greatly help

in building a judical and rational guideline to solve many of the economic problems facing us today.

(1) Islam is comprehensive in nature and provides vital and suitable principles for regulating all aspects of man's life, spiritual, moral. social, political and economic. Islam studies economic aspect as part of the whole problem of man because economic problems cannot be equitably and satisfactorily solved alone. These problems have very far reaching consequences and are closely linked with social as well as political decisions. Therefore Islam does not study economics of man as a separate subject in water-tight compartments. It is one aspect of the whole man and as such, must be studied in that context.

(2) Islam and its message has relevance for all times, past, present and future and for all nations, black, white or brown. It is not confined to any particular age, nation or country, but outstrips the boundaries of time, space and nationality.

(3) Wealth is universal in character and embraces the whole community because all wealth and property belongs to God. Thus property has two aspects: One immortal right of the community and the other of the individual. Private ownership invokes public aspect, sense of collectivity. Wealth belongs to all and all are equal in owning it. This means that every man should be protected from probable danger or loss leading to poverty and destitution; and every man should secure protection for his brother.

(4) Islam does not distinguish between individuals or groups of individuals within or outside the faith as far as the economic needs are concerned.(7)

(5) Islamic approach is based on reason and justice.It does not reject every new thing or discipline outright as illegal or useless. It studies and examines every new system or situation. It selects what is good and beneficial for man and rejects what is bad, harmful or useless for him. The Muslim World is passing through a transitional phase of economic and social development and is importing ideas and concepts from both right and left. It is therefore incumbant upon the Muslim scholars to find a right solutions to their existing problems, neither from the West nor East, and which does not conflict with the Islamic Shariah. Our Prophet (peace be upon him) showed us the straight way very clearly by an example. He drew a straight line among many crooked and curved lines, and then pointing to the straight line, he remarked, "This is the straight way of God" and then pointing to the crooked ones he said. "These are the ways of devil." In the economic field, especially in banking and

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7. For details see social security system in this book and also volume 1.

and insurance, the right course for us would be to keep what is good and useful in the Islamic system and leave what is bad and useless and against the clear text of the Qur'an and Sunnah of the Holy Prophet.

وَفِي أَمْوَالِهِمْ حَقٌّ لِّلسَّائِلِ وَالْمَحْرُومِ

SECTION TWO

INSURANCE

1

INTROCUCTION

It is incumbent upon the Muslim nation to lead the entire humanity to the Truth since God has made it " ***Ummat-e-Wasat*** " a righteous and noble community which does not go beyond proper limits, but follows the middle course and deals out justice evenly to the nations of the world as an impartial judge, and bases all its relations with other nations on truth and justice." " We have made you a community of the golden mean so that you may be witness in regard to mankind and the Messenger may be a witness in regard to you." (2:142) It is a great responsibility for which the Muslim community is accountable. Just as the Holy Prophet was responsible for conveying the guidance of ***Allah***, in the same way the Muslims are responsible for conveying it to the people of the world. It requires that the Muslim community should become a living witness of piety, truth and justice before the world just as the Holy Prophet bore witness before it, and its words and deeds should suffice to demonstrate to the world the meaning of truth, justice and piety. If they fail to prove in the court of ***Allah*** that they have discharged this responsibility to the best of their ability, they will be condemned there. And they along with their evil geniuses and accomplices shall be accountable for all the evils which prevailed during their term of leadership, if they had shown any relaxation in the performance of their obligation as witnesses of the Truth". (1)

This is a warning to those who think that in the field of economics they should consider the solution as men of economics and not as men of faith and truth. This is the result of western materialism and western imperialism which have badly affected many of our cultured young men (and women) who have allowed themselves to deviate from the path of Islam. The second warning is with regard to the strain we are putting on ourselves by deriving solution to the problems that have neither originally arisen from the Muslim needs, nor have developed in a Muslim society. On the other hand, they have originally

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1. Abu Ala Maududi: ***The meaning of Qur'an*** Vol.1.pp.120–121.

developed in a non-Muslim society and reached us through the invasion o thoughts and ideas etc. The problem of commercial insurance is one example We must first ask ourselves some questions and be left in no doubt about the right answers.Whether we really applied Islam to solve our problems in a prope manner? Whether the problem of commercial insurance will actually appear i our life with the same intensity and ferocity? In fact the answer to both these questions is in the negative. The problem has arisen as a result of nullifying the function of the Islamic treasury (***Bait-al-Mal***). if we revive the function of the Islamic treasury along with co-operation and mutual insurance, we shall not have to discuss the problem of modern commercial insurance and see whether it is legal or illegal in Islam.

The third warning is against choosing the easier solution by trying to find out a gap in any of the differences among the Muslim jurists on matters of details to justify such action or to give legality to non-Islamic solutions. We must exert strenuously to infer genuine Islamic solution for our problems without leaving the '***fait accompli***' weigh heavily upon our conscience, Islam is the '***fait accompli***' but falsehood has prevailed in the world today. (2)

The individual Muslim as well as the '***Ummah***' as a whole are commissioned to translate the Islamic principles into actions culminating in the establishment of truth and annihilation of falsehood. The '***Ummah***' as best of the nations (*Khair-e-Ummah*) should enlighten and benefit the entire world community with its right and just principles and rid the world of its evil and unjust systems and disciplines. To speak frankly, no economic discipline or system can be Islamic unless it conforms completely and absolutely to the *Qur'an* (*Kitab*) and tradition (***Sunnah***) of the Holy Prophet. (3)

Various forms of business contracts valid as well as invalid, were in vogue during the time of the Holy Prophet. He approved those that were in line with the basic principles of ***Shariah*** and rejected others that contained one or more

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2. Prof. Muhammad Qutb, speech at first international conference of Muslim economists, Makkah 1976.
3. Muhammad Yousaf, Ameer Jama'at Islami India, at first International conference of Muslim economists, Makkah 1976.

unlawful elements. And has laid down for the future generations general principles to determine the validity of any business contract or commercial bargain. In the light of these principles Muslims can build their own economies and make business contracts or commercial bargains according to the varying needs and requirements of their time and place. People argue that commercial business is a new and modern form of business contract and did not exist at the time of the Holy Prophet or his companions and therefore did not form a part of the Islamic ***Shariah*** .

Such new problems and situations will continue arising in future and necessitating new steps to adjust them in the Islamic system. Commercial insurance is a contract of exchange according to which insurance companies provide cover and guaranttee against probable loss in return for premiums. Even though the extent of loss or damage is unknown or unspecified the insurance contract is perfectly legal and valid in ***Shariah*** . They insist that there is no consensus among the Muslim jurists, including Imam Abu Hanifa, Malik and Shafai and also ***zahiris*** that all contracts are valid until proven otherwise.

Similar opinions have been expressed by some ' modern ' Muslims as well to adopt commercial insurance on the western pattern in the Islamic system without any change in it. It is true that there is urgent need to devise some comprehensive system to solve this and other economic problems facing the ***Millet-e-Islamia*** all over the world but it does not mean that we have to conform new systems to Islam or ***vice versa*** under all circumstances without judging their validity. There are two powerful systems facing us i.e., capitalism and communism and both these systems have different disciplines to suit their own specific and defined ends which are opposite and often hostile to the Islamic principles. Many of these disciplines have already perforated and infiltrated in our system and commercial insurance is one of these. Victims of accidents and various forms of calamities find no redress nor any solution to their problems and therefore fall easy prey to the much advertised and publicized alleged beneficial insurance companies.

" Insurance is indeed a product of modern capitalism, though some collective form of diffusions and compensations for loss were already known in the ancient world and in the middle ages. It is a child of capitalist acquisitive

society, which is built on the competition of private enterprise, of which the taking of risks is the main manifestation. Risks may arise under any economic system but the peculiarity of the capitalist ststen us that it is left to private individuals or bodies to assume them. The greater part of productive and distributive activities of the present society is organised by entrepreneurs, who employ labour, and take on themselves the risk of the functioning of the enterprise."

It is therefore very essential that the problem of insurance should be dispassionately considered and necessary steps taken to remedy the existing situation.

Islamic ***Shariah*** has laid down general principles governing the terms and conditions of a business contract or commercial bargain, so long as any contract of exchange (insurance or non-insurance) does not outstrip these boundaries it is perfectly legal and valid. The Islamic ***Shariah*** cannot accept or immitate any discipline or system merely because it is popular and is practised by other people or civilised nations of the world. Before any system or discipline can be adopted we must take account of all its possible implications and analyse its nature , scope and essential ingredients. The primary objective of our analysis after establishing the usefulness and need of any discipline or system is to see that it conforms with the basic principles of Islamic *Shariah*. Commercial insurance is a form of business. The right course of action should be to accept it as a valid form of business if it conforms with the Islamic principles and reject it outright if it contravenes any of the basic principles of Islam. This is the right attitude of a Muslim. He tries to fit the shoe to the hoof and not the hoof to the shoe. If any changes or alterations are to be made they must be made in the shoe (commercial insurance, its nature, structure or requirements) to make it fit and conform to the shape and size of the hoof (i.e., the principles of the Islamic ***Shariah***) , and not in the shape or size of the hoof (i.e., principles of ***Shariah***) to fit or conform it to the shape and size of the shoe (i.e., the nature, form or structure of insurance contract. In fact this is what the ' modern ' Muslim scholars are suggesting, a little pruning of the basic principles of ***Shariah*** to make it conform to the needs of their commercial insurance.

There is absolute unanimity among the Muslim jurists that all forms of business contracts or bargains which contain any of the unlawful elements like interest (riba), gambling (maiser), or uncertainty (garar), are illegal and invalid. Interest

(riba) in all its forms is forbidden by the ***Qur'an*** and ***Sunnah*** of the Holy Prophet, in cash or kind; in sale or purchase contracts; in property or merchandise; ornaments or machines etc. Whether it is in individual bargain or group dealings; on national or international level, it is absolutely forbidden. The real issue is the presence of these unlawful elements in commercial insurance which renders the insurance contract, though by itself perfectly valid and lawful, absolutely illegal in Islam. If insurance could be organised on right principles, free from these unlawful elements, as in case of mutual insurance and co-operative insurance, it will be quite valid and lawful in Islam.

It is proper and in line with the Islamic principles that we should consider mutual insurance and co-operative insurance to solve our problem instead of finding the easy solution and grab the first thing that comes across in our way. This form of insurance is based on the principle of mutuality, co-operation and participation and is in full agreement with the Islamic principles. With the improvements here and there in the scope, structure and organisation of these two forms of insurance many of our insurance needs can be easily fulfilled. Most of the problems needing insurance in our present set up are the offspring of the western system and would never have arisen in a fully functioning Islamic economy where public treasury ***(bait-al-mal)*** with the organisation of its ***zakat*** fund would have met multifarious needs of the people. It is therefore absolutely necessary firstly to restore the role of the Islamic public treasury ***(bait-al-mal)*** and ***zakat*** playing a central role in alleviating the economic miseries and losses of the poor and the destitute. Secondly , to revive the Islamic social security system to meet the economic needs of various sections of the community with inadequate income. And thirdly to organise insurance on the principle of mutuality, co-operation and participation to meet the needs of general public . This three-pronged attack on the economic needs of the people will be fully comprehensive to meet varying situations of the people without any fear of diminution of funds or burden on ***zakat*** fund.

society, which is built on the competition of private enterprise, of which the taking of risks is the main manifestation. Risks may arise under any economic system but the peculiarity of the capitalist ststen us that it is left to private individuals or bodies to assume them. The greater part of productive and distributive activities of the present society is organised by entrepreneurs, who employ labour, and take on themselves the risk of the functioning of the enterprise."

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Islamic ***Shariah*** has laid down general principles governing the terms and conditions of a business contract or commercial bargain, so long as any contract of exchange (insurance or non-insurance) does not outstrip these boundaries it is perfectly legal and valid. The Islamic ***Shariah*** cannot accept or immitate any discipline or system merely because it is popular and is practised by other people or civilised nations of the world. Before any system or discipline can be adopted we must take account of all its possible implications and analyse its nature , scope and essential ingredients. The primary objective of our analysis after establishing the usefulness and need of any discipline or system is to see that it conforms with the basic principles of Islamic *Shariah*. Commercial insurance is a form of business. The right course of action should be to accept it as a valid form of business if it conforms with the Islamic principles and reject it outright if it contravenes any of the basic principles of Islam. This is the right attitude of a Muslim. He tries to fit the shoe to the hoof and not the hoof to the shoe. If any changes or alterations are to be made they must be made in the shoe (commercial insurance, its nature, structure or requirements) to make it fit and conform to the shape and size of the hoof (i.e., the principles of the Islamic ***Shariah***) , and not in the shape or size of the hoof (i.e., principles of *Shariah*) to fit or conform it to the shape and size of the shoe (i.e., the nature, form or structure of insurance contract. In fact this is what the ' modern ' Muslim scholars are suggesting, a little pruning of the basic principles of *Shariah* to make it conform to the needs of their commercial insurance.

There is absolute unanimity among the Muslim jurists that all forms of business contracts or bargains which contain any of the unlawful elements like interest *(riba)*, gambling *(maiser)*, or uncertainty *(garar)*, are illegal and invalid. Interest *(riba)* in all its forms is forbidden by the ***Qur'an*** and ***Sunnah*** of the Holy Prophet, in cash or kind; in sale or purchase contracts; in property or merchandise; ornaments or machines etc. Whether it is in individual bargain or group dealings; on national or international level, it is absolutely forbidden. The real issue is the presence of these unlawful elements in commercial insurance which renders the insurance contract, though by itself perfectly valid and lawful, absolutely illegal in Islam. If insurance could be organised on right principles, free from these unlawful elements, as in case of mutual insurance and co-operative insurance, it will be quite valid and lawful in Islam.

It is proper and in line with the Islamic principles that we should consider mutual insurance and co-operative insurance to solve our problem instead of finding the easy solution and grab the first thing that comes across in our way. This form of insurance is based on the principle of mutuality, co-operation and participation and is in full agreement with the Islamic principles. With the improvements here and there in the scope, structure and organisation of these two forms of insurance many of our insurance needs can be easily fulfilled. Most of the problems needing insurance in our present set up are the offspring of the western system and would never have arisen in a fully functioning Islamic economy where public treasury *(bait-al-mal)* with the organisation of its *zakat* fund would have met multifarious needs of the people. It is therefore absolutely necessary firstly to restore the role of the Islamic public treasury *(bait-al-mal)* and *zakat* playing a central role in alleviating the economic miseries and losses of the poor and the destitute. Secondly , to revive the Islamic social security system to meet the economic needs of various sections of the community with inadequate income. And thirdly to organise insurance on the principle of mutuality, co-operation and participation to meet the needs of general public . This three-pronged attack on the economic needs of the people will be fully comprehensive to meet varying situations of the people without any fear of diminution of funds or burden on *zakat* fund.

2

ORIGIN OF INSURANCE

Definition

A contract of insurance can be defined " as a contract whereby one perso called the " insurer ", undertakes, in return for the agreed consideration, calle the " premium ", to pay to another person, called the " assured " , a sum money, or its equivalent, on the happening of a specified event. The specifi event must have some element of uncertainty about it; the uncertainty may b either (a) as the case of life insurance, in the fact that, although the event bound to happen in the ordinary course of nature, the time of its happening uncertain; or (b) in the fact that the happening of the event depends upo accidental causes, and the event, therefore, may never happen at all. In th latter case the event is called an accident." (5)

Willet, Kulp, Riegel, and Miller and Pfeffer, all provide similar definitions (2,3,4,5). " Underlying these definitions is the concept of risk pooling-o group sharing of losses. That is, persons exposed to loss from a particula source combine their risk and agree to share losses on some equitable basis. The risks may be combined under an arrangement whereby the participants mutually insure each other a plan which is appropriately designated " mutual insurance "; or they may be transferred to an organisation which, for a consideration, called the " premium ", is willing to assume the risks and pay the resulting losses. In life insurance, such an organisation would be a stock life insurance company. While several elements must be presented in any sound insurance plan, the essence of the arrangement is the pooling of risks and losses." (6)

Thus, in very simple words, a contract of insurance is a contract between two parties, the insurer and the insured, the former promises to compensate the latter on the happening of a definite event, in return for his contributions.

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5. Hardy Ivamy, E.R., ***General Principles of Insurance Law,*** London, 1975.p.3.
6 .Mc Gill, Dan. M., Illinois, 1967,pp.25–26.

An insurance agreement involves five essential conditions: (i) there must be a contract of insurance between the parties (ii) the event should involve some amount of uncertainty (iii) there must be a contract for the payment of some amount of money, or some benefit which becomes payable to the insured person on the happening of an event (iv) compensation is promised by the insurer in return for the payment of contributions or premiums by the insured and (v) the event must be against the interest of the insured. (7)

ORIGIN AND DEVELOPMENT

The concept of insurance is closely related to group life. In primitive society, people lived together in families or tribes in which their needs were fully met and protected through co-operation and mutual help. They, therefore, did not feel the need for insurance because they were fully protected against all sorts of risks by the community. When this family or tribal life was replaced by urban life in the ancient civilizations, the individual found himself open to multifarious perils and without the family or tribal protection. (8) "Primitive people discovered no need for insurance, finding their needs fully protected by the family or tribe in which mutuality such as is established by insurance is a living reality. This was not true of the ancient civilisations of Egypt, Phoenicia, Greece and Rome in which the individual found himself exposed to numerous risks without recourse againt the family community." (9)

Under these circumstances, the individual was completely deprived of family or tribal protection and, therefore, he looked for other kinds of safeguards. Thus insurance originated from the human need to find safeguards against the possible risks to himself and his property or interests, but when, how and by what people it was started is shrouded in mystery and obscurity. Recent archaeological discoveries of Babylon has shown that the Babylonians were skilled businessmen who had a clear idea of the commercial contract and the concept of interest. Their neighbours the Phoenocians, must have adopted their concept and have passed it on to the Greeks and then to the Romans who developed it into insurance as it is known today.

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7. Hardy Ivamy, op. cit., 3.
8. Clayton,G. ***British Insurance,*** London, 1971,p.13
9. Dover Victor, ***Handbook to Marine Insurance,*** London,1970, p.1

According to Clayton, " this code reveals that the Babylonians had be excellent businessmen with a very clear idea of the nature of a contract and t value of money as a means of earning more by loans on usury involving simp and compound interest. This can be easily demonstrated by reference to th case with which these ancient people evolved and practised a commerci contract later to be used and known the whole world over as the " contract o bottomry " . " Bottomry is, or rather was, a commercial contract wherei money (or goods) was advanced for trade purposes either as true loans at certain fixed rate of interest under which the lender had no right to any shar in the proceedings of the trading venture, or as mixed loans and partnership which, in addition to the payment of a fixed rate of interest to the lende irrespective of the result of the trading, entitled him to receive a share of th profits, if such profits exceeded a certain sum. This was on the understandin that the borrower should, in consideration of a high rate of interest, be free from liability in the event of certain accidents happening,e.g., failure of good to arrive at their intended destination. Should the goods arrive, however, th borrower would then be liable for repayment of the loan, plus interest.

It was natural that the Babylonians in their ceaseless search for new markets should not only come into contact with the Phoenicians, who were famous fa and wide for their maritime commerce, but also co-operate closely with them it follows that the Phoenicians should notice, adopt and adapt the peculia commercial contract of the Babylonians and provide posterity with an evocative name into the bargain." (10) According to another writer, " " Contracts of bottomry, or respondentia which were very similar to marine insurance, existed in very early times. It was an arrangement by which owners of ships borrowed money at a high rate of interest and did not repay the loan if the ship was lost. This was also extended to other property, so that something like burglary insurance can be traced in the distant past. Loans of this kind were transacted in ancient Babylone, as is shown in the Code of Hammurabi 2250B.C. (11)

Trenerry quotes the code of Hammurabi: " the merchant advanced goods to the trader, who handed him in return a sealed memorandum or inventory containing the value, etc., of the goods, on the understanding that the security and the rate of interest payable were to be at fixed terms; but that in the event of his being robbed on the journey, through no negligence or connivance on

10. Clayton, op, cit., p.13–13.

12. Pendleton, O.W., ***How to find about Insurance,*** London, 1967, p.104

his part, on making a solemn declaration to that effect, he should be freed from the debt (both capital borrowed and interest). This arrangement is given legal force in the code of Hammurabi,(2250 B.C.)."

This is supposed to be the earliest form of a contract embodying the essential features of Bottomry:

(i) " The contract was in some cases for a true loan and not a partnership, in others for a loan with limited partnership.

(ii) The merchandise or money advanced was under the custody of, and used by, the trader, not retained by the lender.

(iii) The trader was wholly free from liability for the debt on the happening of a contingency provided for in the contract.

(iv) The rate of interest was very much higher than that charged on an ordinary loan, which was at that time limited to 20 percent." (11)

" The next stage in the evolution of bottomry was the adoption of the contract by the Greeks as a result of Phoenician trade expansion in the Greek litteral during the ninth and tenth centuries B.C ; and the increasing domination of Greek traders in the Aegean Sea after 800 B.C. But the contract, as in the case of Phoenicians, was not merely adopted - - it was also adapted, even perfected, to such an extent that a number of very notable ninteenth century maritime lawyers had claimed that Greek contractors of bottomry, similar to the one quoted by Demosthenes in a speech against Lecritus, were so nearly identical in nature with those in vogue in London in 1860 that ***mutatis mutandis*** they could have been used at that date." (12)

The main points of the loan contract made by the Greeks were:

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Commenda of Islam), stating the conditions of the loan, which was deposit at the bank.

(ii) The security, which was generally of at least twice the value of the s advanced.

(iii) The period of the loan.

(iv) The rate of interest, which varied from 10% to 12%, for outward voyag only and 22½% to 30% for voyage; penal rates were charged if the conditio were broken.

(v) The risks provided against — which were total loss of principal a interest if the ship was lost or captured at sea; loss of proportions of princip and interest in the event of some or all of the cargo being jettisoned or of ransom being paid.

(vi) Representation of lender on voyage.

(vii) Obligations of borrowers – to take the most direct course; to repay loa to lender, or his representative, or assignee; to declare if money had bee borrowed already on the same grounds; not to give second mortgage on good as such action was held to be fraud by the first as well as the secon mortgagee.

(viii) Captain's powers of borrowing."

"The final stage in the evolution of bottomry in ancient times was th adoption of the custom by the Romans circa 300 B.C., and it is with th Romans that we enter the crucial, and highly controversial stage of th procedure; for some writers forcefully argue that it was here, in Rome, that th principles in the bottomry bond were translated into insurance as w understand it today." (13)

13. Trenerry, op. cit., pp.13-15 and 114-115; and Clayton, op. cit. pp.114-115.

Before analysing the argument of these writers, it seems proper to study once again the basic elements of a valid contract of insurance:

1. There must exist a risk to be insured against;
2. The property must possess value;
3. There must be no possibility of profit;
4. A premium must be paid; and
5. In the case of non-mutual insurance, the insured cannot act as an insurer of the person or persons with whom he is insured.

According to the argument of professor C. F. Trenerry, "these necessary elements were to be found in arrangements effected during late classical times. In support of his argument, he cites three separate sources. The earliest documented reference to marine insurance occurs in Livy (xx111, 48 and49) in which he describes a guarantee given by the Roman Government in 215 B.C. Under the terms of this guarantee, the Government undertook in return for a premium (in this particular case, the premium consisted of goods and supplies necessary for the Roman army in Spain and supplied by the "publicani") to insure the safe arrival of certain other shipments of supplies, shipped by the private trading companies who were the owners of these supplies. This arrangement, possessed all the necessary conditions of a genuine insurance contract, i.e., there existed a risk, the property was of value, and a premium was paid." (13)

An earlier contract "was referred to in a letter written by Cicero to Caninius Sallust, about 500 B.C., in which the former requested the latter to guarantee a sum of money that was to be transported from Laodicea to Rome. "This too", says Trenerry, "possessed all the elements of a genuine insurance contract because:"

1. There existed a property to be insured— — in this case, pecunia publica which obviously did not belong to the guarantors;
2. The risk to be incurred in transit, i.e. the vecturae periculum; and
3. The premium which was paid to render the contract valid."

" Now, since Cicero was refering to a genuine contract of insurance,it follows," Trenerry argues , " that the custom of the shipper entering into a contract with the gurantors for the safe delivery of his shipment was commonly practised and generally understood; for had it been otherwise, it is

more probable that Cicero would have explained to Caninius in far grea detail the nature of his proposed mode of action."

"The third reference is one by Suetonius in his life of the Emperor Claudi According to Suetonius, there was a severe famine in Rome in A.D. 58 whi gave rise to popular demonstrations against the Emperor. This "despera conduct" was due to the fact that no one expected any more food to b imported during the winter season. Claudius, therefore, in order to persua the importers to render a vital service to the state, not only offered to pay fixed bounty, on all imported corn,but also accepted personal responsibili for all losses arising from storms. This definite offer, " argues Trenerry, "wou have formed a contract, which, it is contended, is equivalent to that of mari insurance in its modern form and restricted sense. The essentials of insuran namely: (a) ownership of insured property (b) risk, and (c) premium, are present". (14)

This interpretation of Roman references by Trenerry was rejected by Marsh who argued that "these instances only serve to show that the contractors we to transport the stores purchased by them to the places of their destination the risk of the Republic. They have scarcely a resemblance in anyo particular to the contract of insurance." (15) Similarly, Sir J.A.Park rejecte Livy's reference on the ground that it "seems to bear no resemblance to th contract of insurance for it is nothing more than every well-organised state bound to do by the ties of natural justice." (16)

But the economists are sharply divided on the question of the use of insuran for transactions by the ancient people. "There is, however, a gener concurrence in the view that if the existence of insurance in the modern sens in the ancient world is doubtful and debatable, there is good and substanti evidence of the use of other forms of contract that in their essence and conte resemble insurance, e.g. maritime loans." (17)

14. Clayton, G. op. cit., p. 15-17 and Trenerry, op. cit. p. 118-119
15. ***Law of Insurance*** (1802) , 1. i, 7 quoted by Clayton, op. cit.,p. 16
16. ***System of the Law of Marine Insurance*** (1842), p. L IXx quoted b Clayton, op. cit.,p 16

A cursory reading through the arguments of Trenerry, Clayton and other writers of this school of thought, show that they are trying to make a mountain out of a mole hill. The contract of bottomry, as practised by the Babylonians, Phoenicians, Greeks and finally the Romans, was an elementary form of insurance in those times in all parts of the world. It was a rudimentary form of something like insurance, but did not contain the essential elements of modern insurance.

Any early signs of modern insurance in a scientific form seem to appear in the European countries in the middle of the thirteenth century. We find many examples of marine insurance in this century in many parts of Europe. "The early practice of marine insurance in a scientific form, and on the "premium" basis, is undoubtedly associated with the merchants of the cities of Lombardy and notably Florence (A.D. 1250) in Italy,. In the Middle Ages, trade was mainly centred in the Mediterranean, with well-known trade routes to the East (to Constantinople and India) and to the North. The Northern Italian cities, Florence, Genoa, and Venice became centres for banking, commerce and insurance." (18)

It is confirmed by Professor Grossmann, that "the first precursors of insurance institutions were the funeral associations ***(collegia tenuiorum)*** which were formed during the period of the Roman Empire by craftsman, merchants and actors- - Italy boasts the first known "insurance agreement", which was executed at Genoa on thirteenth October 1347.A second agreement was signed in Palermo in 1350. In 1369, Marine Insurance was legally regulated in Genoa. And marine insurers sought the assistance of the re-insurer at a very early stage; the oldest documentary evidence of this is a "reinsurance agreement" executed at Genoa on 12 July 1370." (19)

And we find marine insurance in vogue in Spain around the same period. "The intensive trading by Barcelona, for example, with Italy and the seaports of the Eastern Mediterranean since the end of the fourteenth century caused Marine Insurance to flourish early in Spain. The earliest agreement known bears the date of the 12 April 1428. On the 21 November 1435, by the Insurance Ordinance of the Magistrates of Barcelona, Marine Insurance was for the first

18. Dinsdale, W.A.,***Elements of Insurance,*** London, 1965, 17.
19. Grossm ann Marcel, ***Insurance Markets of the world,*** Zurick, 1964, 89

time, regulated by legal confirmation of existing practices." (20)

Then marine insurance spread to France, England and other countries
Europe. "Marine insurance was practised in London in the early part of t
fifteenth century, and the methods employed followed those used by t
Italians. Admiralty and Common Law Court records refer to disputes und
such policies. There is in evidence, a policy written in Italian dated the
September 1547. Privy Council records contain references to Marine Insuran
contracts in the sixteenth century." (21)

France had experience of marine insurance in the fifteenth century. "Tr
contracts of Marine Insurance first appeared in the fifteenth century at
Rochelle and Marseilles. (22) Literature on martime codes, sea laws, a
marine insurances were first published in 1542 under ***Le Guidon*** and *Cinsu*
de la Mer. The earliest work treating of insurance in France is a publicati
known as ***Le Guidon.*** It treats mainly of Marine Insurance. It also mentio
Life Insurance, observing that while it was practised in other nations, it w
prohibited to insure the lives of persons in France. The first serious moveme
for Life Insurance was made in 1787. From ***Le Guidon,*** it appears that
1500, the practice of Marine Insurance was general in France, Spain, Ita
Flanders and England. It is also probable that insurance was practised at a st
earlier period at Marseilles, and the other cites of the South of France." (23)

This record of insurance practices is strong evidence that marine insurance d
not exist in the European countries before the thirteenth century. It also show
that the practice of marine insurance first began in Italy and Spain, and the
spread to other European Nations, including France, England and Germany.
also suggests that marine insurance was probably practised by the marchants
Marseilles and of other cities of the South of France at a still earlier period.
so, then those people must have learned it from the Muslims who ruled th
part of the European contnent right up to the fifteenth century. Mari
insurance spread to the other nations of Europe either from the Peninsula

20. Grossmann Marcel, ***Insurance Markets of the World,*** Zurich, 1964, p. 143
21. Grossmann, p. 169
22. Grossmann, p. 52
23. Walford, Cornelius, ***The Encyclopaedia of Insurance,*** VOl. 1V – Londo
1876-pp. 290- 309

Spain, which the Muslims ruled from the early eighth century to the fifteenth century, or from Italy, the Southern part of which, including Sicily and other islands in the Mediterranean, was under the domination of Muslims for a long time. There is no historical evidence to link the Roman contract of Bottomry with the fourteenth century marine insurance of the Europeans except through the developments that had taken place under the Muslims during this gap of about 800 years between the Roman influence and the Western revival.

Muslim Contributions

By the end of the eighth century, the Muslims had developed marine science, marine navigation and had built a strong naval unit in the Mediterranean. "Abdur Al-Rahman laid basis of the first naval unit in Muslim Spain. He appointed his first Chamberlain, Tammam, as its head. Tammam thus became the first Muslim Admiral in Europe. Under Abdur Al-Raham 111 the Arab navy became the most powerful in the Western Mediterranean. The fact remains, however, that Spain, under Islam reached economic and cultural heights unattained before, and its capital vied with Constantinople and Baghdad as a world centre of grandeur, affluence and enlightenment. Arab writers styled Cordova the "bride of all Andalus" and an Anglo-Saxon nun called it the "Jewel of the world". (24)

The Muslims made great progress in all sciences and all fields of knowldge from which the Europeans benefitted enormously. "Their reservoir of knowledge had many outlets, and much of what they passed on was enriched by their original contributions. The Bidpai fables, lost in Persian, survived in their Arabic tendition to become a source of new versions in no less than forty languages from Iceland to Malaysia. Al-Khwarizam's tables (***Zij***), revised in Muslim Spain, were translated into Latin in Toledo and served as the model for later astronomical tables in the West as well as in the East. From the pen of Ibn Masawayh we have a medical treatise on fevers which was translated into Hebrew and Latin."

"But the greatest scientific mind of the age (810-832) was Al-Khawarizmi. Bisides his astronnomical activity, including membership in the team of Banu-Shakir, he composed the oldest work on arithmetic and wrote

24. Hitti, Ohilip K.;***Malers pf Arab History,*** London, 1969 - 69-71.

" Hisab al-Jabr-wal-muqabalah " (calculations of intergration and equation the first book on Algebra. Translated into Latin in twelfth century Toledo, th work was used for four centuries as a textbook in European universitie Together with Al-Khwarizimi's astronomical works, it was responsible fo introducing into Europe, the Arabic numerals called ' ***algorism*** ' after th author. Thanks to the intellectual productivity of this and other Arab scholar Baghdad took its place as the scientific capital of the world, paralleling Athen as its philosophic, Rome as its judicial and Jerusalem as its religious capitals.

Arab translators and researchers mediated oriental learning and Gree philosophy to the West . The Spanish Muslim, Ibn Rushd (Averroes, 1126–98 was the last link in the chain that dragged Aristotle through the back door int the continent of his birth.(25)

The Muslim scholars studied the old knowledge of the Greeks and th techniques of the Romans, adopted the useful ones and enriched them wit their own new divine knowledge and personal skills and passed them on to th next generation. This is how every new generation benefits from th achievements of its predecessors, makes its own contribution and passes on th enriched heritage to future generations. The Muslims were no exception to th general rule. What is surprising is the attitude of many of the Western scholar and writers, who deliberately confuse the clear evidence of history an completely ignore the part played by the Muslims in the development o modern knowledge and sciences from the end of the seventh century to th end of the fourteenth century, and try to trace the link to the Romans and th Greeks in every branch of knowledge, including marine insurance.

Trenerry is fully aware of this historical process of learning by every successiv generation from its predecessor, when he mentions the Babylonians an phoenicians: The phoenicians themselves had for many centuries, been learnin business habits from the Babylonians, with whom they had the closes commercial relations; the Babylonians being the great land traders and carriers It becomes, therefore, almost a certainty that the phoenicians, when the acquired from the Babylonians a knowledge of the contract of bottomry, a practised by them, should have submitted it to the Greeks, but in an altered form. As the Babylonian trade was a land traffic, their contract provided fo losses by land journeys only. For a similar reason it is to be assumed that th phoenician contract would have applied to marine risks alone, whence it would follow that the Greek contract derived from the phoenicians would, at any rate, have started by being adapted to marine risks. This was the case, not only at the start, but all through the history of the contract as confined to Greece, which tends to support the theory that the Greeks were indebted to the phoenicians for the introducton to them of the Babylonian contract." (26)

" The Roman in their turn appear to have been indebted to the Greeks for a knowledge of this contract, either in the seventh century or later, when the Roman Commission on law went to Athens in the fifth century B.C. As shown by professor Mommsen, the language and writing of Latium indicate that the early Latin commerce was confined almost exclusively to the inhabitants of the Greek colonies of Cumae and Sicily. This introduction probably took place in or about the seventh century B.C. " (27)

But Trenerry refuses to give any weight to the suggestion that the Muslims could have acquired the knowledge of the contract of bottomry, improved it and passed it on to the European nations during their close contact with them in Spain and Southern Italy. The Muslims were sole rulers of land and sea in the East and West during the Middle Ages. Their ships, carrying men and cargo, sailed far and wide in the Eastern and the Western Seas without hindrance. They formed many companies and associations in the form of ***Shirkat Ainan*** (unlimited partnership) and ***Mudarbah*** (limited partnership) and even traded through agencies from the various trading centres established all over the Muslim Empire. The contracts of partnership or Agency were commonly practised by them as early as the eight century. These contracts were very comprehensive and contained every detail of the terms and conditions of the business. This is confirmed by the fact that the British partnership Act of 1890 contains many of the conditions and terms of the Muslim contract of partnership described in Hedaya written around the eight century and translated in English by Charles Hamilton in 1870.

Despite his prejudice against the Muslims, even Trenerry could not avoid mentioning Muslim contributions to the contract of bottomry, though in a

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26. Trenerry, op.cit.,8.
27. Trenerry, op.cit.,11.

very vague way in his discussion on the religion of Insurance. Describing th origin of bottomry, he states that the form of contract for loans wa originated before 2250 B.C by the Babylonians, who developed it from a trading custom similar to that known, as the ' ***Commenda of Islam*** ' and which can be described as follows:

" A capitalist, manufacturer, etc, having money, manufacturing products, etc., on which he wished to make a profit by putting them into circulation, entered into business relations with hawker or Trader, to whom he advanced money manufactured goods, etc. (if money, it was on the understanding that it should be used to buy wares) on condition that he took the wares to other and distant markets with a view to trading with them to the best advantage. A list having been drawn up setting out the quantities and values of all the money, jewellery manufactured goods, or raw produce advanced to the trader, and approved was sealed by both parties and handed to the lender as receipt. The security given by the trader for what was in some cases, a loan and not a partnership arrangement, in others a loan with certain contingent profitsharing, was, firstly his stock, and ultimately, himself, family and property in town, country on the road or stock." (28)

The main points of similarity between this contract of loan of money, or of goods, etc., for trading purposes and that of bottomry, are as follows:

(i) " The contract was for a true loan in many cases; in others it provided for sharing of profits over a certain minimum, but was never for a pure partnership.

(ii) The merchandise or money lent was wholly or partially under the custody of, and used by, the Trader, not retained by the capitalist or merchant.

(iii) The Trader was wholly freed from liability as to the debt on the happening of a contingency provided for in the contrac. (28)

Thus, in all essentials, the concept of the contract of loans on bottomry was present, *mutatis mutandis,* in the laws governing the loans for trading purposes under the *Commenda of Islam* as well as the Babylonians. The only difference

28. Trenerry, op.cit.,pp.5–46 and 56–59.

was that the Muslims made all their contracts and practised trade on this basis without involving the element of interest at any stage of business,while all the others, including the Babylonians, Greeks and Romans, also practised it but interest formed an important part of their contract.

It is an historical fact that the Muslims excelled above the rest of the world in the field of commerce, trade and industry, and dominated the oceans of the East and West, including the Mediterranean sea, from the beginning of the eighth century to the end of the fourteenth century. In the words of Philip K. Hitti, " During all the first part of the Middle ages, no other people made as important a contribution to human progress as did the Arabs, if we take this term to mean all those whose mothertongue was Arabic and not merely those living in the Arabian Peninsula... For centuries, Arabic was the language of learning, culture and intellectual progress for the whole of the civilised world, with the exception of the Far East. From the ninth to the twelfth century there were more philosophical, medical, historical, religious, astronomical and geographical works written in Arabic than in any other human tongue." (29)

Arab ships travelled to the East as far as China, East Indies and the Philipines in the Pacific and to the Islands in the middle of the Atlanties Ocean in the West. According to Ernest-Renan, " Their passion for travel is one of the most striking traits of the Arab character, and one of those which have helped them to make their deepest mark on the history of civilisation. Up to the time of the great impetus in Spanish and Portuguese navigation, in the fifteenth and sixteenth century, no people had contributed as much as the Arabs to broadening man's conception of the universe and to giving him an exact idea of the planet on which he lives, which is the pre-requisite of all real progress."(30)

Arabs had been familiar with the contract of partnership, its basic principles and with all its business complications and had practised it since the eigth century. They were also fully aware of the contract of insurance and they insured ships as well as cargo on the principle of mutuality during all these years. Their main trading centres were spread all over the Indian and Pacific

29. ***Pre'cis d'Histoire des Arabes (Short History of the Arabs)*** Payot, Paris, 1950.

30. Se'dillot, L.A., quoted by Haidar Bammate, op.cit.,pp.45–46.

Oceans in the East and Sicily, Cordova and Seville, in Spain and other towns
North Africa around the Mediterranean Sea in the West. Their traders travell
without interference, in ships in all directions, carrying all kind of goods wh
were fully insured. All their insurance business was conducted on the basis
mutuality and there was no element of interest or usury. The victims of the
peril were paid out of the funds collected from the members of the Mut
Trading Societies.

Even before the Ministry of Muhammad (P.B.U.H.), the Makkan merchants h
formed a Fund on this basis to help the victims or survivors of natural hazar
or disasters during their trading journeys to Syria, Iraq and other countries.
so happened that once, when Muhammad (P.B.U.H.), was engaged in trade
Makkah, a whole trading caravan, apart from a few survivors, was lost in
desert. The managing board, composed of the members of the Contributo
Fund, decided to pay the price of the merchandise, including the value
camels and horses destroyed, to the survivors and the families of those w
perished in the disaster out of the common fund. Muhammad, who w
trading with the capital of Khadijah, had also contributed to that Fund fr
his profits.

Although there is no record of any marine insurance in the West prior to t
fourteenth century, Arab ships, fully insured, voyaged uninterrupted from
East to the West. Western writers have tried to find a link, first between
rudimentary from the Greek bruial societies and the Anglo-Saxon Guild, a
then between the Roman burial society and the modern insurance. " Th
new developments, " saya Clayton, " centred on the guilds, those typica
medieval institutions about which so much has been written but about wh
so little has been said. This is hardly surprising since the origin of the guilds
particular, is peculiarly difficult to trace. Yet, despite the controversy, o
thing is certain,... that although there is an abvious discontinuity between
collegia of the Roman Empire and the latter-day Anglo-Seson guilds, a
although there were obvious differences in their functions, in one fundamen
respect they were identical, i.e., in their very ***raison d'etre***, for both owed th
existence to the natural manifestation of the associative spirit inherent
mankind." (31)

31. Clayton, op,cit.,p.20.

Blinded by racial and religious prejudice, the writer does not admit the truth of how the Renaissance came about in Europe and brought knowledge to the West through its contact with the Muslims of Spain and Turkey. The writer simply skips over this period of about 800 years by calling it as ' an obvious discontinuity between the ' ***collegia*** ' of Roman Empire and the latter-day Anglo-Saxon guilds. ' The European writers generally call this period ' The Dark Ages ' .

Clayton first assumes the origin of marine insurance in Rome and then concludes " that as there is no persuasive evidence to the contrary, the Romans must be condidered the originator of the marine insurance." (32) Even though there is strong historical evidence that the Muslim ships sailed in the international waters in the East and the West for over 800 years and enriched the human culture and civilisation through their contribution to the various sciences and arts, including marine navigation and marine insurance, he does not consider this ' persuasive enough ' to break through the barriers of his racial religious prejudice against the non-white Muslims and to make him admit the truth of history.

The fact is that the Muslims had developed marine techniques long before the fourteenth century. They had used the compass, unknown to the Western World, centuries before this period. " The Arabs invented the mariner's compass, and voyaged to all parts of the world in quest of knowledge or in pursuit of commerce. They established colonies, far to the South in the Indian Archipelago, on the coast of India, and on the Malayan Peninsula. Even China opened her barred gates to Muslim colonists and mercenaries. They discovered the Azores, and, it is even surmised, penetrated as far as America. Within the confines of the ancient continents they gave an unprecedented and almost unparalleled impulse in every direction to human industry." (33)

The Italians, being neighbours, were the closest to these developments and were, therefore, very likely to have adopted the technical and commercial skills, including marine insurance, of the Muslims. Clayton admits that the earliest trace of marine insurance in Italy goes back only to the fourteenth

32. Clayton,op.cit.,pp.23–24.
33. Ameer Ali, op.cit.,pp.391–92.

century. "The first trace of marine insurance in Italy dates back from th early fourteenth century. Pagalotti, for instance, in treatise dated 1350 refe to the insurance contract as a *"rischio de mere e di genti"*, while in an earli work he says that Florentine bills in England contained one or other of th phrases *" rendu sauf en terre"* or *"en aventure de mer et des gens"*, and th excess charge made when the first phrase was substituted for the secon represented in effect a premium for insurance."(34)

Again, he asserts that, "there seems little doubt that as soon as insuranc became a practice on northern Italy and Bruges, it also became a practice i Spain, so close were the trade connections between Barcelona, Pisa an Florence. It would be superfluous at this point to draw attention, therefore, t early Spanish policies. Suffice it to say that Spain deserves special mentio rather because Barcelona was the first city to attempt to regulate the practi of marine insurance by ordinance." (35)

Here he has mentioned Italy and Spain with regard to the insurance practic First, we take Italy: if the Romans were the originators of insurance, then th Italians should have been practising it since the earliest century of the Christi era,as they inherited it from their forefathers. There is no logical basis to thi otherwise for the Italian administration had enjoyed political continui without any foreign, military or political intervention. But the evidence o history does not support such a suggestion that the Italians ever practise marine insurance before the fourteenth century, and the critic fully agrees wi it." (36)

The fact is that the Italians, Spanish and other European nations had n knowledge of marine insurance before the Middle Ages. These nation especially the Spanish and the Italian from their close contacts with th Muslims, should have known the contracts of insurance and marine insuranc but the Vatican supremacy in Europe during that period could not ha tolerated acquistion of knowledge of any kind from the heathens (Muslim were called by that name by the Christians), and must have destroyed ever trace of it as is confirmed by historical evidence.

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34. Clayton, op. cit., p. 24.
35. Clayton, op. cit., p. 28.
36. Clayton, op. cit., p. 23-4.

And, as the Europeans, including the Italians and the Spanish, did not possess the knowledge of marine insurance before the fourteenth century, it is quite logical to examine and analyse the channels through which they acquired this knowledge and then spread it to the rest of Europe. It seems more probable that those countries which came into contact first with the Muslims during that period, acquired the knowledge of marine insurance, marine science and other techniques before the rest of the Western World. The first contact of the Europeans with the scientific achievements of the Muslims came through Spain. The Muslims (moors) ruled Spain for about 800 years (from the early eighth to the fifteenth century) and greatly enriched the culture and scientific heritage of Spain.

When the Muslims finally left Spain at the end of the fifteenth century, the Spaniards found themselves greatly enriched by the scientific and technical heritage left by their rulers far ahead of other European nations. Spanish and Portuguese navigators began their ventures around the world about this time and began to establish their colonies in South America, West Africa and India. Columbus had some hint of the existence of the American continent from a Muslim geographer of that time.

Then the Dutch traders and navigators began their ventures to the East and landed in India and the East Indies. Shortly afterwards, the English and the French began their sea ventures to the East and the West and gradually superceded the others in many regions.

It seems most probably that the Europeans learned new marine science and marine navigational techniques partly through the Italians and Spanish, and partly through their direct contact with the Muslims of Spain and the Turks during the long religious wars, called the Crusades. Among other things, they also learned and adopted marine insurance from the Muslims. Our opinion is supported by the fact that marine insurance was never practised in any European country before the thirteenth or fourteenth century , while it was an ordinary and common practice among the traders throughout the Muslim World. The Muslims had known the basic principles of the Law of contract, including marine insurance,with all its business and financial complications and had practised it since the eighth century. The Europeans came into close contact with the Muslims from three different dirctions; firstly, through Spain where Muslims ruled for about 800 years; secondly, through Italy, as the Muslims controlled the Mediterranean Sea and all its Islands , including, Sicily,

Malta, Cyprus, Crete, not to speak of Southern part of Italy; and lastly, dur
the Crusades, they became acquainted with the scientific discoveries, learn
the way of life of the Muslim Turks.

The European became fully conscious of the achievements of the Muslims
the field of science and art during these conracts and saw its practical rel
in the advancement of their culture, civilisation and living. And gradually th
were fully convinced of the usefulness of sciences and art in life wh
Christian churches of Rome had condemned as 'magic' and 'sorcery'. T
realisation of the great potential of knowledge in its application to the practi
problems of man laid the foundation of a movement in the West, commo
known as 'Renaissance' which paved the way for modern Europe.

It is argued that most of the records of marine insurance were written in La
which, according to them, is a clear evidence that marine insurance originat
in Italy. In fact, many of the records were kept in Latin because it was t
language of Christendom, and it was regarded as heresy to disobey
command of the Roman Catholic Church. Gradually, it became a fashi
especially among the rich and aristocratic, to learn and speak classical Latin
is not surprising, therefore, to find insurance records in the Admiralty fi
written in Latin. In no way does it prove that marine insurance originated
Italy or spread to the other European nations only through Italy.

3

HISTORY OF BRITISH INSURANCE

The earliest form of insurance in Britain originated from the idea of family as it occured in the Low Countries and in Germany. With the break up of the family idea, its economic functions grew weaker, so the guild was organised to fill this widely-felt need. " This was, in essence, the need for social security," and as Walford remarks, "they seem (i.e., the guilds) on the whole to have been Friendly Associations made for mutual aid and contribution to the pecuniary exigencies which were perpetually arising from burial, legal enactions, penal ***mulcts***, and other payments and compnensations."

"Yet this was not their only function. The first guilds of which we have any record, were the eighth century guilds of Flanders, which had as their object the mutual insurance of their members against all risks, including loss of property through robbery. The first English guilds of which we have any knowledge, the guilds of Cinhts, offered mutual aid for recovering stolen cattle and this was, as Walford remarked, "very much in the nature of an Insurance Association, yet proper burial of dead, with its concomitant panoply of pomp and splendour, formed the cornerstone of these and later guilds and fraternities, as can be seen from the ordinances of the fraternities of Cambridge, Abbotsbury and Exeter.

"This principle of mutual insurance carried forward and became, likewise, an integral feature of both merchant and craft guilds. It even survived the destruction of the guilds and came to reside in the "box clubs" and Friendly Societies of the seventeenth and eighteenth centuries." (1)

According to E.A. Woods, "in the Middle Ages the craftsmen's guilds took care of the dependants and provided for the burial of their members; and when the guilds gradually passed out of existence or were abolished by sovereign command, other agencies sprang into existence which substantially filled some of the essential funtions of the former guilds. One of these was proper burial

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1. Clayton G. ***British Insurance*** – London 1971 - pp. 20 -21.

of the dead." (2)

And in the words of another writer, "These organisations, sometimes cl
under social insurance, differ both from insurance operated by the state
origin, they are mutual aid societies established by the poor classes as a he
against sickness and misfortunes. An early mention of friendly societies a
be found in Defoe's Essys on Projects in the chapter so named. He calls
'another branch of insurance which is by contribution. Much later, w
friendly societies had become established institutions, their aim is descri
pretty well in the title of a book by Sir F.M. Eden, published in 18
Observations on Friendly Societies, for the Maintenance of industrial cl
during sickness, infirmity, old age and other exigencies." (3)

It is difficult to determine the earliest marine insurance contracts in Brita
but probably insurance was practised in this country later than in Spain
Belgium. Records of insurance were made in the sixteenth century, though
Lombards, a non-English merchant firm, organised insurance long before
We hear of English contracts of insurance after the proclamation of the fam
Elizbethan Act of 1601 in respect of insurance. And the earliest known Lloy
contract dates back to February 1613. Harold E. Rayners says that "
earliest marine policy relating to this country is dated 20, September, 1547
short document of fourteen lines relating to a marine insurance from Cadi
london." (4)

However, the records of the Court of Admiralty have shown policies dat
back to 1524 and 1547. (5) "A very clear picture of the state of ma
insurance in London in sixteenth century can be built up from Admir
(6) But marine insurance in the sixteenth century is characterised by
complete absence of corporate character. There was no body of m
specialising solely in insurance underwriting and occupying the same premi

2. *The sociology of Life Assurance*– 1928–p. 99.
3. Gosden, op. cit.,p. 4–5. Defoe, D., ***Essays on Projects,*** p. 163. quoted by
Osden, P.H.J.H., ***Friendly Societies in England*** 1815–75
4. Dover Victor. ***A Handbook to Marine Insurance,*** London, 1970. p. 112.
5. ***A History of British Insurance,*** 1948–p. 10.
6. Clayton, op. cit., p.29

as was later to be the case of Lloyds, for insurance."(7)

" Defoe was quick to recognise this fundamental weakness, ' for I believe anyone will grant me this; it is not the smallness of the premiums (that) ruins the insurer but it is the smallness of the quantity he insures. ' (8) In other words, the underwriters of the time were carrying on business with insufficient capital; their operations were casual and often extremely speculative. The business called for organisation on a large scale, for adequate information and for greater technical precision in the estimation of risks and the fixing of premiums, so that both insurer and insured might be more fully protected." (9) In fact, British insurance was organised on a more uniform basis after the enactment of the 1601 Act concerning marine insurance. This Act established a Court to hear cases arising from insurance policies.

There was no fire insurance before the Great Fire of London in 1666; it was introduced after the tragedy in the last quarter of the seventeenth century. The City of London established a fire insurance company about November 1681 and at the same time, a private ' insurance office for houses ' was established in London. (10) Gradually, the scope of fire insurance was extended to cover factories, warehouses and mills and also spread to other cities outside London. Thus, " by adapting old classifications to meet new needs, by varying premiums according to the degree of risk within any given classification, and by manipulating the upper insurance limit, the scope of fire insurance was adapted to meet the needs of an ever-changing society." (11)

The Lloyds ' Coffee-house had become an important underwriting centre for the shipping business by the middle of the eighteenth century. (12) By 1770 the foundation of the modern Llyods ' was laid when the Committee of Llyods ' was set up to manage affairs of the company. The number of its 79 of its original subscribers had risen to170 by1774.The reason for its success lay in

7. Clayton, op. cit., p.30.
8. Clayton, op. cit.,p.31.
9.Essays, op. cit., 163–quoted by Clayton, op. cit., p.31–32.
10. Clayton, op. cit., p.36–37.
11. Clayton, op. cit.,p.46.
12. Clayton, op. cit., p.57.

its superior efficiency. " Apart from its efficient of shipping intelligence, whi by itself would have been sufficient to guarantee its pre-eminence, it also beg to record ships lost or safely arrived. This gave Llyods' a clear advantage, whi it continued to build upon in the years to come."(13)

However , " during the latter part of the 1760s, a wave of speculative gambli forced a group of marine underwriters to break away from Llyods' Coffe House. The object of the ' precious habit ' of gambling was the lives of th great men. A passage from John Francis ' Annals of Life Assurance, will serv to remind us of the practice. 'Policies ', he says, ' were opened on the lives o public men with a recklessness at once disgraceful and injurious to the mora of the country... There was absolutely nothing on which a policy could b opened that was not employed as the opportunity of gambling."

" The danger inherent in these speculative ventures sprang from the absence o what is known as " insurable interest " (14). Thus, the whole history o insurance up to the last quarter of the eighteenth century, was an unhapp story of gambling or wagering and exploitation by the insurance companie The Insurance Act of 1774 was passed to stamp out wagering from the field o insurance but, unfortunately, it failed to achieve any tangible results. (14)

The main provisions of the Insurance Act of 1774 are set out in the followin four sections: (15)

1. No Insurance to be made on lives, etc., by persons having no interest etc. " That no insurance shall be made by any person or persons, bodies political or corporate, on the life or lives of any person or persons, or any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering; and that every assurance made contrary to the true intent and meaning hereof shall be null and void to all intents and purposes whatsoever."

13. Clayton, op. cit., p.72.
14. Clayton, op. cit., p.72.
15. Clayton, cop. cit., p.72–73. Ivamy, op. cit.p.551; and Holder, E.A. ***Houseman's Law of Life Assurance,*** London, 1966, p.16.

2. No policies on lives without inserting the name of persons interested, etc. " That it shall not be lawful to make any policy or policies on the life or lives of any person, persons or other event or events, without inserting in such policy or policies the persons name or names interested therein, or for whose use, benefit, or on whose account such policy is so made or underwrote."

3. How much may be recovered where the insured hath interest in lives. " That in all cases where the insured hath interest in such life or lives, event or events, no greater sum shall be recovered or received from the insurer or insurers than the amount of value of the interest of the insured in such life or lives or other event or events."

4. Not to extend to insurance on ships, goods, etc. " Provided, always, that nothing herein contained shall extend or be construed to extend to insurances *bona fide* made by any person or persons on ships, goods, or merchandises, but every such insurance shall be as valid and effectual in the law as if this Act had not been made."

Life insurance, in its earlier stages, was linked with the growth of marine trade, because the marine risk insurers very often agreed to insure also the lives of the captain and his crew But these life policies were of very short duration for this insurance terminated with the completion of the voyage. " However, towards the end of the seventeenth century, attention was drawn to possibility of establishing funds which would undertake to pay annuities with benefit of survivorship." (16)

Another attamp was made to establish a society for Assurance of Widows and Orphans in 1699, " this was a scheme of mutual benefaction involving 2,000 subscribers whereby on the death of any one of them, the survivors paid five shillings each, so that the widows might receive £500... It was a short step to the mutual society in which premiums contributed by its members would be shared amongst the descendants of those who died, the total sum available depending upon the actual number of deaths per annum." (17) But all such

16. Clayton, op. cit., p.64.
17. Clayton, op. cit., p.64–65.

societies established in the last decade of the seventeenth century and the firs
decade of the eighteenth century " were extremely rudimentary for they a
lacked a firm scientific foundation." (18)

There were quite a few attempts made by individuals to launch life insurance
societies during the eighteenth century, especially between 1718 and 1776, bu
because of the lack of knowledge of mathematics of probability and of life
contingencies progress was slow. In fact, scientific life insurance in this period
was only a family affair. (19)

Period 1800-1850: Marine insurance developed rapidly during this period
owing to the growing needs of the merchant community for protection against
the risk of loss through storms, fire, war, etc., and the demand was reflected in
the establishment of Lloyds'. (20) This was equally true of fire insurance. (21)
But life insurance developed later than either marine insurance or fire
insurance, mainly because of the lack of a scientific basis before 1760. (22) By
1806, the number of subscribers to Lloyds' had increased to 1,500, for they
offered better security to the insured than could be given by any other
chartered company. (23)

Successive acts were passed in 1824 and 1825 to help the insurance business
but still it was not recognised in the eyes of the law. (24). This deficiency was
to some extent rectified by the Chartered Companies Act of 1837. But " even
now all was not well because unregulated and often fraudulent companies
requiring no returns of their purposes, deed of settlement, shareholders or
capital, could continue to conduct business." (24) The Act for the
Registration, Incorporation, and Regulation of Joint-Stock Companies finally
rectified this deficiency. (24)

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18. Clayton, op. cit., p.65.
19. Clayton, op. cit., pp.65–75.
20. Clayton, op. cit., p.79.
21. Clayton, op. cit., p.81.
22. Clayton, op. cit., p.81.
23. Clayton, op. cit., p.81.
24. Clayton, op. cit., p.99.

After this business expanded and, as before, along with genuine companies, many fraudulent companies came into existence and increased their business as well. " Once again, insurance promotion featured heavily in the speculations. In terms of nominal capital, fire and life insurance constituted the largest single class of speculative enterprise, whilst, in terms of capital actually paid up, they constituted the second largest class. Needless to say, a great number of companies floated during this period of speculation, were utterly fraudulent and soon collapsed, as exposed by the Select Committee of 1841. However, inspite of set-backs, insurance rapidly grew, so much so that by 1850, British pre-eminence in the now virtually important sphere of insurance had become an established fact. No less than 236 insurance companies had been promoted of which by far, the greatest number, 157, transacted life assurance, 64 companies were underwriting fire insurance and 46 dealt in marine (insurance) business." (25)

The most important act of this period in relation to insurance was the Gaming Act of 1845. The object of this act was to stop all insurance contracts which in substance were wagering, and this is shown by its main provisions on this subject.

" That all contracts or agreements, whether by parole or in writing, by way of Gaming or Wagering, shall be null and void; and that no suit shall be brought or maintained in any court of Law or Equity for recovering any sum of money or valuable thing alleged to be won upon any Wager, or which shall have been deposited in the Hand of any person to abide the Event on which the Wager shall have been made: Provided always, that this enactment shall not be deemed to apply to any Subscription or Contribution, or Agreement to subscribe or contribute, for or toward any plate, prize, or sum of Money to be Awarded to the Winner or Winners of any lawful Game, Sport, Pass-time, or Exercise." (26)

Period 1850–1914: another class of insurance, known as accident insurance, came into being in this period and made great progress. The enactment of the Boiler Explosions Act of 1882 made it obligatory for every boiler explosion to

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25. Clayton, op. cit., pp.104–110.
26. Clayton, op. cit., p.117.

be reported to the Board of Trade and the guilty party was ordered to pay part or whole of the cost of the enquiry. In 1890, the provisions of the 1882 Act were extended to any explosion occurring aboard a British ship and in 1901, official control and supervision was intensified by the Factory and Workshop 'Act. This led to an enormous increase in business for engineering insurance companies. (27)

The real forerunner of motor insurance was the Law of Accident insurance Societies passed in 1901. (28) Therefore, the growth of motor insurance was very rapid. Another notable feature of this period was the rapid rise in individual life insurance. Although it was very successful, " considerable number of societies and companies tried their hands at the business and failure was not uncommon. Thus there developed a growing feeling that the whole business of industrial life assurance was a thinly disguised swindle organised at the high rate of lapse and the high expense ratio. As a result, the Annuities Act of 1865 was passed which enpowered the Postmaster-General to conduct life assurance business. Again, the Annuities Act of 1882 was passed to improve upon the previous act, but it made only minor changes in the administration of the scheme and did not tackle with the basic defficiencies.(30)

State intervention did little in the way of improvement but successive legislative measures and public enquiries kept the problem alive. At last the Life Assurance Companies Act of 1870 was passed to regulate insurance corporations. Its main provisions were:

1. " Every company established in the U.K. had to deposit a sum of £20,000 with the Accountant-General of the Court of Chancery, refundable when its life assurance fund reached £40,000.

2. Every company had to keep a separate account for the life and annuity business and all receipts emanating from this class of business had to be assigned to a distinct " life assurance fund."

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27. Clayton, op. cit., p.1118.
28. Clayton, op. cit., p.120.
29. Clayton, op. cit., p.123.
30. Clayton, op. cit., p.124.

3. Specialist life offices had to furnish revenue account and balance sheets in a prescribed form and composite companies, revenue account for life, fire, marine and other classes of business, if any.

4. A company was obliged to submit its financial condition to investigation by an actuary, once every five years if established after the Act, and at least once every ten years if established earlier. An abstract of the actuary's report, containing details of date of valuation, proportion of primium reserved for future expenses etc., was to be deposited, along with the other information enumerated above, at the Board of Trade."(31)

Criticism of the insurance companies continued and led to the enactment of Friendly Societies Act of 1875. "This act provided facilities for the formation of friendly societies and laid down rules for their conduct. The basic intention was to protect the members from management abuses, whether in the form of provident handling of funds or unfair conduct towards individuals. For the first time this Act recognised individual assurance as a separate entity. It also prohibited new societies from accepting members under the age of 16 years. It also enacted that no forfeiture should be incurred through defaulting on payment of contributions until written notice of liability to forfeiture had been delivered to the defaulter, giving a policy holder at least 14 days to clear any arrears. It also forbade companies to transfer the policies from one office to another without the policy-holder's written consent. This was to protect policy-holders from possible loss of benefit through transfer from one office to another."(32).

Though the Act provided the legal framework for the conduct of individual insurance, it failed to solve the problem which beset the industry.The question of lapses remained unaswered. The workers were still poor and, as a result, a large number of premiums fell in arrears and many policies lapsed. There was also no shortage of business crooks who would make policy-holders terminate their existing insurances and get re-insurance through them. Thus, 'transfers' became an object of public 'censure' in the latter part of the nineteenth century.(33)

31.Clayton, op. cit., p. 125
32.Clayton, op. cit., p.126
33.Clayton, op. cit., p. 127–129

Further criticism centered on the new companies' effort to evade the legal payments of a deposit of £20,000 under the 1870 Act with the Board of Trade. In addition, the fraudulent persons acquired control of derelict insurance companies whose registrations were never cancelled, and entered business as 'old companies', thereby avoiding a deposit. There was sufficient evidence to suggest that lapses were too common and management costs too high and the authorities had insufficient powers to enforce the law. (33)

The Employers Liabilities Act of 1880 imposed a liability on employers for accidents to their employees. Its main weakness was that it applied to very few types of individual accidents. (33)However, Workmen's Compensation Act was passed in 1897. It applied to more hazardous occupations only but it enabled workmen to receive compensation for occupational accidents from the employers without proof of negligence. (33)

The Workmen's Compensation Act of 1900 extended the scope of the Act to cover agricultural workers and the Act of 1906 provided cover for all kinds of workmen. (34) The Marine Insurance Act of 1906 had the following main provisions with regard to insurable interests and wagering: (35)

1. "Every contract of marine insurance by way of gaming or wagering is void.

2. A contract of marine insurance is deemed to be a gaming or wagering contract:
(a) Where the assured has not an insurable interest as defined by this Act, and the contract is entered into with no expectation of acquiring such an interest.
(b) Where the policy is made "interest or no interest" or "without benefit of salvage to the insurer", or subject to any other like term: Provided that, where there is no possibility of salvage, or a policy may be effected without benefit of salvage to the insurer.

3. Subject to the provisions of this Act. every person has an insurable interest who is interested in marine adventure.

4. In particular, a person is interested in a marine adventure where he stands in any legal or equitable relation to the adventure, or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, by damage thereto, or by the detention thereof, or may incur liability in respect thereof.

5. The assured must be interested in the subject-matter insured at the time of the loss though be he not interested when the insurance is effected. Provided that where the subject-matter is insured "lost or not lost", the assured may recover although he may not have acquired his interest until after the loss, unless at the time of effecting the contract of insurance the assured was aware of the loss, and the insurer was not.

6. Where the assured has not interest at the time of the loss, he cannot acquire interest by any act or election after he is aware of the loss.

7. A defeasible interest is insurable, as also is a contingent interest.

8. In particular, where the buyer of goods has insured them, he has an insurable interest, not withstanding that he might, at this election have rejected the goods, or have treated them as at the seller's risk, by reason of the latter's delay in making delivery or otherwise.

9. A partial interest of any nature is insurable.

10. (a) The insurer, under a contract of marine insurance, has an insurable interest in his risk, and may re-insure in respect of it.
(b) Unless the policy otherwise provided, the original assured has no right, or interest in respect of such re-insurance

11. The lender of money on bottomry or respondentia has an insurable interest in respect of the loan.

12. The master or any member of the crew of a ship has an insurable interest in respect of his wage.

13. In case of advance freight, the person advancing the freight has an insurable interest, in so far as such freight is not repayable in case of loss.

14. The assured has an insurable interest in the charges of any insurance which he may effect.

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34. Clayton, op. cit., p.129
35. Brown, R.H. ***Marine Insurance, vol. 1***. London, 1968. pp. 192-194.

15. (a) Where the subject-matter insured is mortgaged, the mortgagor has insurable interest in the full value thereof, and the mortgagee has an insurable interest in respect of any sum due or to become due under mortgage.

(b) A mortgagee, consignee, or other person having an interest in subject-matter insured may insure on behalf and for the benefit of persons interested as well as for his own benefit.

(c) The owner of insurable property has an insurable interest in respect of full value thereof, not withstanding that some third person may have agreed be liable, to indemnify him in case of loss.

16. Where the assured assigns or otherwise parts with his interest in the subject matter, he does not thereby transfer to the assignee his rights under contract of insurance, unless there can be an express or implied agreement the assignee to that effect."

The Marine Insurance Act of 1906 replaced all the previous Acts of insurance of 1745, 1774 and 1788. But the provisions of this section do not affect transmission of interest by operation of law.

In 1909, the Assurance Companies Act was passed to rectify the abuses which could and did arise in insurance business as a result of the 1870 Act. This Act brought within its scope life, fire, accident, employers ' liability and bond investment insurance, etc. (36)

At the end of 1911, efforts were made by the Liberal government for direct participation by the state in the insurance industry. The National Insurance Act of 1911 was a compromise under which direct state intervention was avoided by inviting the co-operation of the industrial offices and requesting them to administer the statutory scheme. It laid down three conditions concerning the establishment of appoved societies.

36. Clayton, op. cit., p.130

Firstly, they must not be conducted for profit; secondly, they must be controlled by a majority vote of insured members; and thirdly, they must not be societies which periodically divided their funds. (37)

Another important feature of this period was the process of amalgamation and absorption of smaller offices into larger and more powerful groups of companies dealing in all classes of insurances. This was done partly to reduce the high cost of management, partly to maintain and improve market penetration by offering a side range of insurance services, and partly to secure greater efficiency and well-balanced business. This led to the remarkable expansion of British insurance in overseas markets during this period.(38)

The Period 1914–45. During this period, the insurance industry had to face the difficult times of the two World Wars and generally had to carry the load of war risk at peacetimes. However, the state was generous enough to insure underwriters in times of war. (39) And in spite of set backs, insurance industry made steady progress in these years as shown by the following tables. (40)

TABLE 1

PREMIUM INCOMES (IN £ BILLIONS)

Year	Fire Insurance	Life Ass.(ordinary)	Life Assurance (industrial)
1914	28.8	32.2	17.9
1915	29.9	32.4	18.5
1916	31.8	33.0	19.5
1917	36.0	33.2	20.9
1918	41.7	37.0	22.3

37. Clayton, op. cit., p.131.
38. Clayton, op. cit., pp.136–142.
39. Clayton, op. cit., p.150.
40. Clayton, op. cit., pp.152–156.

TABLE 2

PREMIUM INCOME OF SELECTED BRANCHES (IN £ BILLIONS)

Year	Life Assurance (Ordinary)	Fire	Personal Accident	Marine Insurance
1918	37.0	41.7	2.2	-
1928	72.7	59.0	3.9	-
1937	76.8	48.3	4.5	1+.3
1939	91.6	49.6	4.5	14.7

TABLE 3

RESERVE FUNDS (IN £ BILLIONS)

Year	Fire R.F.	Life Assurance Fund (Ordin.)	Life Assurance Fund(Industrial)
1914	27.9	390.0	58.7
1915	29.1	390.4	61.3
1916	30.5	395.1	64.9
1917	32.6	396.3	64.4
1918	36.1	411.0	74.0

These tables show the rates of growth of the insurance industry during the w years. "Thus despite the fears and apprehensions generated by the war, t insurance companies, by and large, emerged from it in a stronger financ position than when they had entered. And life premiums , it will be see continued to expand despite the depression and even during the trough of t depression exceeded the post-war peak of 1928."(41)

41. Clayton, op. cit., pp.153–156

Though the insurance industry, on the whole, made rapid progress, lapses and surrenders continued in life assurance at an increased rate as shown by the following tables: (42)

TABLE 4

INCOME FROM PREMIUMS AND SURRENDERS
(IN £ BILLIONS)

Year	(Ordinary) Life Premiums	(Industrial) Premiums	(Ordinary) Surrenders	(Industrial) Surrenders
1936	98.0	53.6	8.3	4.5
1937	99.7	55.7	8.1	4.5
1938	102.0	57.9	9.2	4.5
1939	99.4	59.8	10.3	3.9
1940	96.4	62.1	9.9	2.3
1941	95.5	63.5	6.8	1.3
1942	99.8	67.9	5.7	0.9
1943	103.5	72.1	4.9	0.9
1944	109.6	75.7	5.1	1.0
1945	117.4	79.3	7.0	1.7
1946	134.5	83.5	11.6	3.0
1947	158.8	91.1	11.5	3.6
1948	172.9	97.1	13.6	5.4

Table 4 shows an overall increase in the premium incomes from life assurance, while Table 5 shows the growth of premium incomes from other types of insurance during this period.

42. Clayton, op. cit., p.192

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42. Clayton, op. cit., p.192

TABLE 5 (43)

GROWTH OF PREMIUM INCOME OF NON-LIFE INSURANCE (IN £ MILLIONS)

Year	Accident	Fire	Marine	Motors	Misc. Accident
1938	4.6	49.5	12.8	37.8	34.0
1939	4.5	49.6	14.7	36.5	N'A.
1940	4.0	51.0	22.5	31.9	33.2
1941	3.9	54.4	2.4	34.0	37.2
1942	4.0	56.3	39.1	28.3	39.4
1943	4.3	59.9	30.0	24.6	45.5
1944	4.7	65.0	26.3	26.4	48.2
1945	5.1	71.1	22.6	33,8	49.8
1946	6.2	88.2	27.1	46.9	57.9
1947	7.7	108.6	40.8	61.7	73.1
1948	8.5	127.6	50.5	70.7	73.8

Table 6 shows the growth of profits, especially with regard to life and ma insurance policies. Marine and life insurance experienced a remarkable incre in premiums as well as in profits. Marine income rose by 400 per cent du 1938-1948 and about 260 per cent during 1948-68, while life premiums rose 175 per cent and 350 per cent respectively during the same periods. Tables 6 a 7 show the growth of profits of the insurance industry.

43. Clayton, op. cit., pp.192–195

TABLE 6 (44)

GROWTH OF PROFITS AND LOSS (in £ Millions)

Year	Fire	Accident (Personal)	Accident (Misc.)	Total Accid.	Marine	Life
1948	9.8	0.9	7.4	8.1	3.6	3.2
1950	16.9	1.0	8.0	25.2	4.8	3.4
1956	4.6	1.5	9.8	0.6	5.1	6.7
1957	3.8	0.8	9.1	0.3	4.3	5.5
1958	7.6	1.0	11.4	0.8	2.7	4.6
1959	4.9	1.6	8.9	11.6	3.0	7.7
1960	7.3	1.6	9.2	6.5	4.9	6.0
1961	5.3	1.1	11.3	5.5	6.8	6.9
1962	8.9	0.9	4.7	6.4	7.5	11.7
1963	21.6	0.09	9.0	10.9	7.4	10.8
1964	5.2	1.1	8.5	8.5	6.6	9.3
1965	5.7	1.4	5.9	1.8	0.6	15.0
1966	4.8	1.7	6.0	1.2	6.7	13.2
1967	7.6	2.0	N.A.	8.2	9.3	11.2
1968	4.0	N.A.	–	N.A.	–	N.A.

There has been a tremendous increase in the profit of the insurance industry, especially life and marine insurance since the Second World War. Marine profits increased by 300 per cent and life insurance by about 400 per cent. The growth of profits is reflected in the growth of the life and annuity funds of the insurance industry as shown in the Table 7 below:

TABLE 7 (45)

ORDINARY AND INDUSTRIAL LIFE BUSINESS (In £ Millions)

Premium Income	1935	1938	1955	1960	1965	1967	1968
life and	161	167	493	734	1,100	1,353	1,509
Annuity) Funds	1,269	1,467	3,618	5,432	8,640	10,311	11,389

44. Clayton, op. cit., p. 271
45. Clayton, op. cit., p. 234

TABLE 8

ANNUAL RATE OF GROWTH (Cumulative Percentage)

	1935–38	1938–55	1955–60	1965–68
Premiums)	3.0	6.0	8.0	11.1
Life and) Annuity Funds)	4.9	5.4	8.5	9.7

TABLE 9 (46)

NON–LIFE BUSINESS (In £ Millions)

	1935	1938	1955	1960	1965	1966	1967	1968
Premium) Income)	107	142	626	921	1,289	1,378	1,493	1,792
General) Funds)	118	150	487	628	783	813	926	1,085

This remarkable growth in insurance industry, especially life insurance, indicates " that the income elasticity of demand for lide insurance is certainly greater than one. It is supported by the evidence in Table 10 which shows that premium income has been a growing proportion of personal income in recent years". There is every hope that life insurance will further expand as the income per head rises in the country." Life insurance in force in Canada and

46. Clayton,op.cit., p.235
47. Clayton, op. cit., p. 243

the U.S.A. represents 195 per cent and 164 per cent of national income respectively as compared with 98 per cent in the United Kingdom." (47)

TABLE 10 (48)

RELATIONSHIP BETWEEN PERSONAL DISPOSABLE INCOME AND EXPENDITURE ON LIFE ASSURANCE IN THE U.K.

Year	Total Personal Disposable Income £M (1)	Expenditure on Life Premiums £M (2)	(2) as a % of (1) (3)
1957	15,341	396,9	2.6
1961	19,552	532.3	2.7
1964	23,383	759.1	3.2
1967	27,559	1,080.8	3.9
1968	29,304	1,224.0	4.2

Thus income seems to be a major determinant of the demand for the services of insurance, except such branches of insurance wherein legal requirements also play an important role, e.g., motor insurance. The motor insurance has received a real boost in recent years because the motor vehicle has become a common feature of every day life. With the increasing prosperity and growth in the United Kingdom's capital stock the demand for fire insurance has also considerably increased during these years. (49) Likewise, marine insurance has also developed quite fast as shown by Tables 6 and 11.

48. Clayton, op. cit., p. 244
49. Clayton, op. cit., pp ..210-211

TABLE 11 (50)

PREMIUM OF MAJOR BRANCHES (IN £ MILLIONS)

Year	Life (Ord.)	Life Indust.)	Fire	Marine Aviation Transit	Accident (Personal)	Motor
1918	37.0	-	41.7	-	2.2	.
1928	72.7	-	59.0	-	3.9	.
1937	76.8	-	48.3	11.3	3.6	.
1939	91.6	-	49.6	14.7	4.5	.
1945	109.5	79.3	71.7	48.5	5.1	33.8
1969	1160.0	286.0	1053.0	181.0	-	633.0

The dominant influence on the insurance industry during the inter-war period was that of the depression, and the intensification of legal supervision and state intervention.(50) But the old criticism , namely, of excessive expense ratio, excessive lapse ratio and other abuses relating to funeral benefits, was revived with greater intensity. These deficiencies were ascribed to overselling by agents. The Industrial Assurance Act of 1923 was passed to rectify these defects. Its main provisions were:(51)

1. " The Registrar of Friendly Societies was to become the Industrial Assurance Commissioner who was granted important statutory powers including the right to require offices to make returns to him. Where a deficiency was revealed he could order the society to be dissolved or apply for the Court Order to have the company wound up.

2. The conditions under which free paid up policies and surrender values were to be granted , were enumerated.

50. Clayton, op. cit., p. 152–156 and 211
51. Clayton, op. cit., p.161

3. Industrial assurance for the purposes of the 1909 Act was to be treated as a separate class of insurance which meant that a separate deposit of £20,000 was required and distinct fund and revenue account was to be recorded in the returns." (52).

Another branch of insurance which came into the lime-light during the inter-war period was employers' liability. A departmental commitee was set up to look into the problem of the payment of compensation to workmen for injuries and the possibility of a system of accident insurance under the control and supervision of the state.(53).

The committee was disturbed to find the excessive amount of profits made by companies from employers's liability business, for it was found that average profits amounted to 15.2 per cent of premium income during the eight years from 1911–18. A new workmen's Act was passed in 1923. Another Act, called the Workmen's Compensation (Coal Miners) Act was passed in 1934. This Act provided for compulsory workmen's compensation insurance in the coal-mining industry.(53)

The failure of the companies during this period prompted the government to appoint the Clauson Committee in 1924 to enquire into the state of the insurance industry in general and especially the working of the Assurance Companies Act of 1909.(54). As a result of its enquiries, the Assurance Companies (Winding up) Act was passed in 1933 which gave greater powers to the Board of Trade to bring about the winding up of a company but the Act was defective. The government passed another act, known as the Assurance Companies (Winding up) Act of 1935 to deal with this matter more effectively. (55)

In 1939 the War Risks Insurance Act was passed which introduced a war risk insurance scheme for commodities prohibiting the private insurance of stocks on land.(56) This virtually granted the government a monopoly. It appointed the

52. Clayton, op. cit., p.161
53. Clayton, op. cit., p.162–165
54. Clayton, op.cit., p.166
55. Clayton, op.cit., p.167
56. Clayton,op. cit.,p.177

insurance companies and the Corporation of Lloyds' as Government agents to collect premiums to pay them back to the Board of Trade. Then in 1941, the War Damage Act was passed to extend state intervention in the insurance industry still further, but it excluded buildings, business, plant and equipment and chattels.

"In 1940, the Government was obliged to pass the Industrial Assurance and Friendly Societies (Emergency protection from Forfeiture) Act to protect the interests of industrial life policy-holders. Under its provisions holders of industrial life policies which had been taken out more than two years before 1 september 1939, for sums assured of less than £50, who fell into arrears with premiums, could apply for protection from forfeiture on the grounds that default was due directly or indirectly to war. The industrial Assurance Commissioner was authorised to instruct that the policy should or should not be protected. And protected policies could not be allowed to lapse. (57)

An inter-departmental committee headed by Lord Beveridge was appointed in 1941 to lay the plans for the Welfare State. Lord Beveridge asserted in his report that there should be a complete suppression of private insurance business. He based his claim on the fact that:

1. "An assurance contract is for a long term of years; the customer cannot change his commodity if he is dissatisfied and therefore should be provided with disinterested advice.

2. That industrial assurance was already so closely related to State insurance through the approved societies that it was easier to make the association closer than to break it.

3. That it was a feature of the business that it required little or no investment of capital." (58)

1945–70: This was a period of reconstruction, recovery and growth. (59) We find that in spite of inflation and Britain's failure to readjust her economy fully to the forces released by the Second World War, and the consequent balance of payments crises, the growth in insurance business, as measured by premium income has broken all previous records, as shown by the Tables 4,5 and 6.(60).

The insurance industry was faced with new challenges in this period. Insurance companies calculate their premium rates of interest and are quite happy when the rates of interest are rising. This is because there is a considerable lag between changes in the latter and adjustments in the former. The policy of 'cheap money' since the Labour Government came to power in 1946, followed by 15 years of low rate of interest, presented a great challenge to the Insurance Companies. The companies had to raise premium in order to protect themselves. But in the seventies, with the rise in the rate of interest, the problem receded and now the insurance companies enjoyed a high yield of over nine percent in Government Securities.(61).

The case for the nationalisation of industrial life insurance was revived in the post-war years and the commercial insurance was criticised on the ground that there were overlapping services, overselling, high rate of lapses and the failure of the companies to utilise their financial resources in the national interest.(62) Although due to strong opposition, the threat of nationalisation receded, the industry was subject to increasing legal control in the form of the Acts of 1946 and 1947. The former extended the application of the 1909 Act to include marine, aviation and transit insurance and increased the deposit to £50,000. It also tightened up the need for solvency by stipulating that insurance companies would in future be regarded insolvent if their assets were not more than their liabilities either by £50,000 or one-tenth of their premium income in their last financial year.(63)
financial year. (63)

Owing to the failure of some companies, an Act was passed to prevent a repetition of this kind by increasing the deposit to £100. It also increased the powers of the Board of Trade to control the new firms and to prevent the solvent companies from transacting business. (63)

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57. Clayton, op. cit., pp. 179-180
58. Clayton, op. cit., pp. 186-188
59. Clayton, op. cit., p. 196
60. Clayton, op. cit., pp. 197-221
61. Clayton, op. cit., p. 214
62. Clayton, op. cit., p. 216

The companies were now facing the effects of inflation in the form of ris expenses (of selling and commissions) and claims, as well as the impac technological change on the size of industrial risks. In order to meet increasing costs, the companies were paying more attention to the interes their policy-holders through shifting their investment policies towards eq which offered better protection against the falling value of money and more emphasis on the bonus element in with-profit policies. (64)

The technological revolution suddenly changed the nature and size of the involved in the sea or the land, as well , as a result, the size of marine insura risk and industrial life insurance risk multiplied. (65) The increasing liabi and the big risk also became important features of fire insurance. T challenge of rising costs was met by economy in expenses through amalgamation of smaller companies into bigger units with increased efficie and financial resources. (65)

ANALYSIS OF THE PRESENT BRITISH INSURANCE

The main feature of "all forms of general insurance is that the contract is annual one. The premium is paid in return for the promise of an indemnity the specified contingency occures during a given year; if there is par damage, an indemnity is paid to cover the actual loss. The contract in li insurance is usually a long-term one and the premiums are normally paid ove period of years." (66)

In life insurance, the occurrence of the event on which claim is paid, is certa while in general insurance, the particular event against which insurance required, e.g. fire, personal accident etc, may never happen to the individu policy-holder. "It is this distinction which is the basis for using "assuranc when describing the various types of life business and "insurance" for gener business." (67)

63. Clayton, op. cit., p. 216
64. Clayton, op. cit., pp. 217-218
65. Clayton, op. cit., p. 218
66. Clayton, op. cit., p. 228
67. Clayton, op. cit., p.229

The major types of life assurance contracts are: firstly whole-life policies under which premiums are paid through the life of the policy-holder for an agreed sum payable at death. Secondly, Endownment Assurance policies under which the policy-holder contracts to receive a specified sum at the end of a fixed period or at death, whichever happen first. Then there are 'pure' endownment policies which do not give any death benefit. There are also Annuities contracts under which the insurer guarantees income for life in return for a fixed 'lump-sum' payment. (67)

Life assurance has certain special features which distinguish it from other forms of insurance. First, "the degree of consumer ignorance is markedly greater in life assurance than in general insurance. This is partly because there is a bewildering variety of different products and partly because the determination of the premium involves the application of sophisticated statistical techniques.

All life assurance policies, with the exception of term insurance, are a combination of insurance and investment. The policy-holders are insured against premature death and are also promised an amount of money at the end of a specified period. Thus a part of the premiums represents the price of pure insurance cover, and a part to ensure the payment of the final instalment."(68)

There is an increasing tendency among the policy-holders to buy a policy which contains an element of life as well as endownment assurance. This provides greater protection for their dependants against the risk of poverty through their premature death, and security to themselves against poverty in old age. But this form of mixed life insurance does not provide as much financial protection to the dependants as they would receive under a purely life assurance policy, nor does it provide sufficient cover to the policy-holder as he would receive under a purely endownment policy. (69)

"Another important distinction is between "with-profits" and "without profits" policies. In the latter the insurer contracts to pay a fixed sum of

68. Clayton, op. cit., pp. 249-250
69. Clayton, op. cit., p. 248.

money, either in the event of the death of the policy-holder or on his attainment of a certain age, but in the former he offers to pay a certain sum plus an additional bonus the size of which will depend on the profitability and success of the insurer's operations. A modern variant of a " with profits " endowment policy, which came into existence a few years ago, is one which is linked to units in such a way that the amount which is paid out on the expiry of the policy depends not on the profits of the insurance company but on the performance of the unit trust to which the policy is linked. In some version the same objective is sought by the establishment of a special investment fund by the insurance company. These schemes are specially designed to appeal to policy-holders who are liable to pay surtax." (70)

Having considered the nature of the product, we now turn to the problems of the determination of premiums. Life assurance policies are very different from general insurance policies because they last for many years during which the premium remains unchanged, even though the risk, against which insurance is sought, may have changed. In view of this fact, the accumulation of funds plays an important role in meeting long-term contracts through the payment of equal annual premiums.(70) However, the actual size of the fund depends upon the inflow of premiums and interest earnings minus tax and the outflow of claims and expenses.(71)

Many other factors may cause variations in premiums that are charged by the life assurance companies to their clients; term insurance, whole life or endowment assurance: the age of the insured and the duration of the contract; " with-profits " and " without profits " policies; assumed rate of interest, yields from the investment of funds; and different loadings added to net premiums. (72) " The main conclusion is the policy-holders in general receive somewhat less for their money than they could have for two reasons. First, they exhibit a widespread cautious preference for the types of policy which place greater emphasis on the element of insurance than that of investment. Secondly, they seem to be woefully unaware of the vast differences in the value for money which they could obtain if they made their choice of policies more rationally. (73)

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70. Clayton, op. cit., pp.248–50.
71. Clayton, op. cit., p.252.
72. Clayton, op. cit., p.253.
73. Clayton, op. cit., p.255.

In general, the level of premiums is determined by the four variables: claims, commission, expenses and profit. The first essential determinant of premiums is claims which contain an element of uncertainty and though it diminishes with size, it will continue to bedevil the estimates for all times to come. Profits are more arbitrary in life assurance than in most commercial enterprises, because they are dependent upon two estimates, namely, estimates of future liabilities and future incomes, and obviously, different companies may vary in making their estimates, and likewise, in matters of commission and other costs. (74)

To sum up, the story of the British insurance industry, especially life assurance is very painful. In spite of a series of legislative acts by the British Parliament since 1772 to rectify the weakness of this business, the problems of profiteering, exploitation, expense ratio, lapse ratio, and cost-price relationships have continued to disgrace the insurance industry with ever-increasing intensity.

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74. Clayton, op. cit., pp.268–273.

4

MUTUAL INSURANCE

Mutual insurance existed in ancient Greece but was normally associated wi burial society. These societies were formed for the worship of divinity a were essentially religious in character. Likewise, Roman burial clubs a societies were organised by people for the worship of divinity. The member the club or society paid monthly contributions to the common fund for possession and maintenance of a common burial ground for the members w also received the funeral rites prescribed in the worship. (1)

Gradually, as the Romans became indifferent to the religious beliefs a religious rites, these societies became purely burial societies and their functi were widened. They began to provide monetary assistance to the relations the deceased and this was a common practice of the societies by the fou century A.D. Some societies began to vary the contributions and, therefo the benefit, in accordance with the social status of the people. (1)

THE ARAB CUSTOM OF BLOOD-MONEY

The Arabs inhabit the peninsula of Arabia which is surrounded by the sea three sides. It is a large desert land south of the fertile valleys of the riv Euphrates and Tigris and quite close in the west to the rich land of the Ni separated by the Red Sea. In olden days, the desert land of Arabia w inhabited by Bedouin tribes who often had quarrels and family feu sometimes lasting for years. Raids by one tribe on another were very comm Sometimes, the raiding tribe would steal the camels, women and children the other tribes, because women and children could be ransomed. The ransom money was collected from all the members of the plundered tribe and paid the head of the raiding tribe who shared it with the rest of his tribe.

1. Clayton, op. cit., p.19.

the case of murder, blood-money (i.e. monetary compensation) was paid by the killer or the tribe of the killer to the relative of the killed. Sometimes the individual killer could not pay the blood-money, so, to avoid blood-shed and blood-feud between the tribes, the money was collected from all the members of the tribe and paid to the relatives or the tribe of the killed. This could be called the beginning of mutual insurance which is a device to reduce the burden of one member of the tribe on the basis of mutual sharing.

In tribal life, each tribe (or group) was united as one unit and the loss of its members was considered as the loss of the entire tribe (or group). If a tribe lost any member, it received compensation (i.e. blood-money) for that loss from the tribe which was responsible for that loss. On the other hand, if a tribe killed any one belonging to the other tribe, it compensated the whole tribe by paying blood-money for that loss.

According to this Arab tradition, the entire tribe was held responsible for the payment of blood-money to the tribe or the relatives of the killed. This co-operation on the part of the whole group or the community to mutually share the burden of its members reflects the spirit of insurance.

BLOOD-MONEY AND MODERN INSURANCE

In short, the object of blood-money is to secure protection against the danger to which all the members of the tribe are equally exposed, and to eliminate a common danger which may fall upon any member of the tribe at any time. Accordingly, the tribe jointly contributed to meet the loss (in blood-money) which might fall upon any of them. In other words, it is mutual coverage of accidental loss by the community exposed to a common danger.

There was great destruction of property and loss of life in the ancient blood-feuds and tribal war fare. So, to avoid this blood- shed and destruction, tribes began to pay compensation on behalf of their members in the form of blood-money for the loss of life to the tribes or the relatives of the killed. Thus the whole tribe in a way offered protection to its individual members against a common danger. It can be said, therefore, that the payment of blood-money is an obvious example of mutual insurance, wherein the whole community stood

guarantee against the loss to any of its members in the form of blood-mo
This communal enterprise was social in character but economic
consequence. (2)

" The underlying principle in mutual insurance is that the individual mem
are themselves the insurers as well as the insured ." (3) In this sen
organisation, there is neither profit-making, nor exploitation, nor enrichm
of the one at the expense of the other. It is a social enterprise organised
eliminate the burden (or loss) of the individual by jointly sharing it.

There is great difference between modern commercial insurance and mut
insurance. In the former, losses are estimated in advance and are not shared
its members, but funds are made available by the insurance company to pay
the losses, whereas in the latter, losses are not estimated in advance but
shared by the members as they occur. Thus modern commercial insura
lacks the basic principle of mutuality which is the core of the mutual insura
institution. (4)

Commercial insurance has all the evils of capitalism, e.g., exploitati
profiteering, enrichment of one at the cost of another, etc. Above all,
converts future unforeseeable risks (or losses) into a fixed cost and the
transfers them, instead of dividing them among the members, to pay for th
losses, which is clearly gambling or wagering.

Distribution of losses among the members in mutual insurance is based on th
humanitarian principle of co-operation, shouldering one another's burden whi
transfer of losses from the insured to the insurer in commercial insuranc
reflects speculative motive for profit on the part of the capitalist. (5) Th
mutual insurance system, as shown by the payment of compensatio
(blood-money) by the group, does not visualise transfer of loss for it is agains

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2. Dr. Muhammad Muslehuddin, ***Insurance and Islamic Law,*** Lahor
1969–p.15.
3. Morgan, T.W. ***Porter's Law of Insurance-London*** 1933 p.47.
4. Barou H. ***Co-operative Insurance,*** London 1936-pp.96.100.
5. Mac Gillivray, E.J. and Denis Browne, ***Insurance Law–London,*** 195
quoted by Dr. Muslehuddin, op. cit., p.17.

the spirit of group life. The group is so closely knit together that its members lose their individuality and become part and parcel of the group. They are completely merged in the group which alone has the right and power to speak and act on their behalf. It takes responsibility for their crimes as well as their injuries and claims their rights and fulfills their duties in all matters. Thus, the Arab system of blood-money may be called a elementary form of mutual insurance established by the members of a group (or tribe), with the insurer as well as the insured, arranging to pay contributions to meet the losses (in blood-money) by any of group's member.

PRINCIPLE OF MUTUALITY AND ISLAM

In the pre-Islamic period, as explained above, it was common practice to pay compensation in blood-money by the family or tribe of the killer to the family or tribe of the killed. Although the individual killer was responsible for the payment of this compensation, in actual practice, it was paid by the family or tribe of the killer. As the members of each tribe were closely related and united together to face the common dangers of desert life, they developed an extreme sense of loyalty to their tribe. Each tribe tried to protect and safeguard the life and property of its members . Gradually, this group loyalty and the inter-dependence of its members developed into mutuality and showed itself in the form of the collective responsibility of the tribe to pay compensation (or blood- money) for the killing of a member of another tribe by one of its own members. It was an accepted custom of the Arabs before the advent of Islam to accept camels, or the equivalent price in cash, as blood-money in compensation for the loss of life.

The usual price paid for a killing in the pre-Islamic period was a hundred camels; for a deep wound, one third of that amount, and for the loss of hand, an eye, or a tooth, five camels. When the blood-money was paid in cash, it was 1,000 or, sometimes, 1,200 dinars (gold coins) which was generally spread over a period of three to four years.

Theoretically, it was the personal responsibility of the killer to make this payment, but, in practice, ultimate reaponsibility fell on the community and the whole group was held responsible for the payment of the blood-money to the family or tribe of the killed.

This was reflected in the behaviour of the tribesmen when any of their me
was killed by a member of another tribe. All of them, individually as w
collectively, felt duty bound to avenge the death of their associate by killi
killer or any member of his tribe. In the words of Watt,"though it is pref
to inflict the penalty on the person responsible for the death or inury, it m
inflicted on any member of of clan or tribe instead of him. It is thus clear
ultimately the responsibility both for the original act, and exacting vengea
communal."(6) The custom of tribal responsibility is further clarified
A.Rahim, when he says,"the principle of punishment for all crimes against
person was retaliation commutable to a payment of blood-money
compensation for the injury. If the injury resulted in death, the loss caused
regarded as a loss to the tribe or the family of the deceased, and was their
to demand satisfaction from the tribe or the family of the offender."(7)

The principle of compensation in kind or cash for the death or injury to
person greatly helped to eliminate or, at least, reduce the tribal warfare
family feuds which lasted for years and caused enormous loss of life
property.This custom had four outstanding benefits for the people of Arabia
(i) It reduced bloodshed and bloodfeuds in the country;
(ii) It replaced individual responsibility with the ultimate collec
responsibility of the tribe for the actions of its members, and thus helped
achieve social security for individual members of each tribe;
(iii) It lessened the financial burden of the individual by transferring it to
group (or the tribe); and
(iv) It developed a spirit of co-operation and brotherhood among the members
reflected in mutuality to share the individual burden amongst the group.

After the advent of Islam, the system of compensation for loss of life, because
its virtues and benefits, was retained in the Islamic discipline. Indiscrimin
killing in tribal feuds which followed the murder of one member of a group
the pre-Islamic period (called *jahilliya* in the terminology of the *Qur'an*)
stopped by the commandment of the *Qur'an:* " O you who believe! the law
retaliation is prescribed for you in cases of murder; the free for the free,

6. Watt W.M., *Muhammad at Medina,* Oxford 1956 p.262 quoted by Dr.Muhammad Muslehuddin,op. cit., p.27
7. *Muhammadan Jurisprudence,* Lahore 1963 p.6 quoted by Dr.Muhammad Muslehuddin, op.cit., p.27

slave for the slave, the woman for the woman. But if any remission is made by the brother of the slain, then grant any reasonable demand, and compensate him with handsome gratitude. This is a concession and a mercy from your Lord. After this whoever exceeds the limits shall be in grave penalty. And there is life for you in retaliation, o men of understanding, that you may ward off evil."(8)

These verses of the *Qur'an* clearly show how Islam tried to mitigate the horrors and blood-feuds of the pre-Islamic custom of retaliation. In order to satisfy the strict claims of justice, equality in retaliation is prescribed with strong recommendation for mercy and forgiveness. Retaliation does not truly express the meaning of the word used in the text (i.e. ***qisas)***. The word ***qisas*** is from *qasas* which means to follow in the footsteps of someone, and ***qisas***, therefore, means to follow up the killer until he is found. Then ***qisas*** is also used for the punishment for which the criminal is found guilty. This may take any of the two forms: firstly, life for life, an eye for eye, or an ear for an ear, etc.; secondly, financial compensation for the family or relatives of the killed or injured. Thus, in its wider sense, the word ***qisas*** covers both forms of punishment. The law in its strict application demands life for life, or an eye for any eye, but God in His all-pervasive mercy, and to maintain the interests of the relatives of the killed, has left the option for them to accept some financial compensation instead of life from the relatives or the family of the killer.

The right of remission is given to the relatives of the killed but the power of enforcement of this decision is ultimately left to the state as is clearly shown by the use of the words, "the law of the punishment is prescribed for you" in the text. A.Yusuf Ali has tried to clarify this point by translating the word ***qisas*** as the law of equality.(9) To translate ***qisas***, therefore by retaliation, is , incorrect. The latin legal term ***'lex talionis'*** may come near to it, but even that is modified here. In any case it is best to avoid technical terms for things that are very different. "Retaliation" in English has a wider meaning, equivalent almost to returning evil for evil, and more fitly apply to the blood-feuds of the days of ignorance. In Islam: " if you must take a life for a life, at least there should be some measure of equality in it; the killing of one man of a tribe should not involve a blood-feud where many men would be killed; but the law of mercy, where it can be obtained by consent, with reasonable compensation, would be better. " If the aggrieved party consents (and this condition of consent is laid down to prevent worse evil), forgiveness and brotherly love is better, and the door of mercy is kept open. But in Western law, no felony can be compounded. (9)

8. *The Qur'an*,2:178–179 9. *The Qur'an:* Footnote 182 p.70

Thus , Islam helped to reduce the severity of punishment and the te
consequences of the pagan custom of retaliation, by adopting and impro
the pre-Islamic custom of compensation for the relatives or the family o
killed. It enjoined upon the believers not to waste human lives in retalia
but to let the law take its course, and if the aggrieved party agreed
reasonable compensation, brotherly love is better than retaliation.
should a believer kill a believer; but if it so happens by mistake, compens
is due. If one so kills a believer, it is ordained that he should free a beli
slave, and pay compensation to the deceased's family, unless they rem
freely." (10)

In the same way, Islam mitigated the horrors of the pre-Islamic custom
retaliation in wounds and injuries by prescribing the law of equality in all
cases. "We ordained therein for them: Life for life, eye for eye, nose for
ear for ear, tooth for tooth, and wounds equal for wounds. But if any
remits retaliation as charity, it shall be an act of atonement for himself."
Again forgiveness and mercy, which is better than retaliation, is recommend
in all such cases in order to avoid bloodshed in the community.

The Holy Prophet fixed the amount of blood-money for life at one hund
camels and he himself paid this amount on behalf of the Jews of Khaibar.
stated by Bushair bin Yasar al-Ansari on the authority of Sahl bin
Hathma Al- Ansari that some men of his tribe went to Khaibar, and they w
separated from one another, and they found one of them slain. And
Messenger paid blood-wit of one hundred camels of *sadaqa*. (12) The H
Prophet also fixed the amount of compensation for wounds and other injur
to the body. Umru bin Shuaib reported from his father that the H
Messenger had fixed five camels as the price of compensation for bone-
wounds. According to Ibn Abbas the Holy Messenger had fixed equ
compensation for fingers and toes; and for the loss of every finger or toe
blood-money was ten camels. Anas reported that Um Hartha, sister of Ra
struck some one and broke his tooth, and the case was brought before
Holy Prophet and she was told to pay compensation for the loss of a toot
Muhammad Bushair reported from Ibn Abbas that the Holy Messenger
fixed the price of blood-money for life as 12,000 dinars (gold coin).

10. *The Qur'an:* 4–92.
11. *The Qur'an:* 5–48

Thus, the principle of compensation and group responsibility was accepted by Islam and the Holy Messenger, as head of the State, paid blood-money to the relatives or family of the victim whenever the killer could not be identified or was too poor to pay it. This is also reflected in the Covenant of Mutuality formed between the immigrants *(Muhajrin)* and the helpers *(Ansars)* as soon as the Holy Messenger arrived in Medina. "In the name of God, the Compassionate, the Merciful. This is a document from Muhammad the Prophet (governing the relations) between the believers and Muslims of *Quraysh* and *Yathrib*, and those who followed them and joined them and laboured with them. They are one community (Umma) to the exclusion of all men. The *Quraysh* emigrants, according to their personal custom, shall pay the blood-wit within their number and shall redeem their prisoners with the kindness and justice common among believers."

"The *B. (Banu) A'uf* according to their custom, shall pay the blood-wit they paid in heathenism; every section shall redeem its prisoners with the kindness and justice common among believers.The *B. Sa'ida*, the *B. al-Harith* and *B. Jusham* and the *B. al-N'ajjar* likewise. The *B. A'mr*, *B. A'uf*, the B. *al-Nabit* and the *B.al-A'us* like wise. Believers shall not leave anyone destitute among them by not paying his redemption money or blood-money in kindness."

"A believer shall not take an ally the freed man of another Muslim against him. The God-fearing believers shall be against the rebellious or him who seeks to spread injustice, or sin or enmity, or corruption between believers; the hand of every man shall be against him even if he be a son of them. A believer shall not slay a believer for the sake of an unbeliever, nor shall he aid an unbeliever against a believer. God's protection is one,the least of them may give protection to a stranger on their behalf. Believers are friends one to another to the exclusion of outsiders. To the Jew who follows us belong help and equality. He shall not be wronged nor his enemies be aided. The peace of the believers is indivisible. No separate peace shall be made when believers fight in the Way of God. Conditions must be fair and equitable to all. In every foray, a rider must take another behind him. The believers must avenge the blood of one another shed in the Way of God. The God-fearing believers enjoy the best and most upright guidance. No polytheist shall take the property or person of

12. *Sahi Muslim* Vol. 111– Lahore 1973– p. 892 No. 41 translated by A.H.Siddiqui.

Quraysh under his protection nor shall he intervene against a believer. Whosoever is convicted of killing a believer without good reason shall be subject to retaliation unless the next-of-kin is satisfied (with blood-money) and the believers shall be against him as one man, and they are bound to take action against him."

"It shall not be lawful for a believer who holds by what is in this document and believes in God and the Last Day to help an evil doer, or to shelter him. The curse of God and His anger on the Day of Ressurection will be upon him, if he does, and neither repentance nor ransom will be received from him. Whenever you differ about a matter, it must be referred to God and to Muhammad (His Messenger)." (13)

Thus all the Muslims of Medina, irrespective of their tribe or clan, became one community through this covenant. The Quraysh and the tribes of Medina were now joined together into one single family, that of Muslim brotherhood, for the mutual support and common defence of their homeland. Umar, the second Caliph widened this community when he ordered the preparation of registers (*diwan*) containing the names of Muslims as brothers-in-faith in all parts of the Muslim state. "The persons whose names were contained in those (diwans) owed one another mutual assistance and had to contribute to the payment of the penalty (compensation)– for manslaughter committed by one of their community." (14)

Thus a group of Muslims was held responsible by the unwritten law of the Muslim state for the payment of the blood-wit for any of its members. In common terminology, it is called ***'a'qila'*** and based on the ideology of common interest. According to the conception of ***'a'qila'***, a clan is committed by the unwritten law of the Arab tribes to pay the blood-wit for each of its members. The basis of ***'a'qila'*** was, therefore, the common interest of the community of the offender, since he was a member of the community. The Hanafi jurists are of the opinion that all the members of a community, who belong to one profession of artisans, constitute ***'a'qila'*** for its members. This is how the concept of ***'a'qila'*** laid the foundation of mutual insurance based on the principle of mutuality and co-operation.(15)

On the basis of this principle, many associations belonging to different professions were formed throughout the Muslim state to help their members in difficult situations. The members of these associations were also provided with adequate facilities to pay compensation by instalments over a number of years. In the course of time, various types of professional associations came into existence to help their members in multi-farious ways on the basis of mutuality and co-operation. By nature, for all practical purposes, these assocations were, infact, mutual insurance companies which were organised on the principle of mutuality, like the co-operative insurance of industrial workers in the twentieth century. The membership of many of these associations was considerably large to lighten the burden of loss to their members. Sometimes the number of members of these associations was so large that the actual contribution did not exceed more than three or four Dirhams per head. (15)

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13. Guillaume, A., ***The Life of Muhammad,*** translation of Ibn-Ishaq's *Sirat Rusul Allah,* Lahore, 1970, pp. 231-233.
14. Dr. Muhammad Muslehuddin, ***Insurance and Islamic Law,*** Lahore, 1969 pp. 31-33.

15. Hedaya. Vol. 4, p. 642 quoted by Dr. Muhammad Muslehuddin op. cit., p. 30.

5

1. THE NATURE OF MODERN INSURANCE

Modern commercial insurance is based on the law of large numbers and mathematics of probability. "Insurance relies heavily upon the law of large numbers. In a large homogeneous population it is possible to estimate the normal frequency of common events, such as deaths and accidents. Losses can be predicted with reasonable accuracy, and this accuracy increases as the size of group expands. From a theoretical standpoint it is possible to eliminate pure risk if an infinitely large group is selected. From the standpoint of insurer, an insurable risk must meet the following requirements;

(1) The objects insured must be numerous enough and homogeneous enough to allow a reasonably close calculation of the possible frequency and severity of losses.

(2) The insured object must not be subject to simultaneous destruction.

(3) The possible loss must be accidental in nature, and beyond the control of the insured.

(4) There must be some way to determine whether a loss has occurred, and how great a one." (1)

This is why insurance contracts specify very definitely what events must take place, what constitutes loss, and how it is to be measured. The necessity and desirability of a statistical basis for insurance is best described in the following words: "But fixation of a contribution (known as a premium) of losses over a period can be ascertained in advance. Thus insurance in its modern form became practicable only when statistical records of past experience can be collated with sufficient accuracy to warrant quantitive assumptions about

1. ***Encyclopaedia Britannica,*** Vol. 9, p. 645.

future experience. If records for a particular vicinity show that one house in 200 is burnt down every 15 years, a statistical basis is available for determining the premium required to cover this contingency in the future. With this development the stage is reached when the insurance can be undertaken by outside parties. The scheme and its administration need no longer be a matter of mutual organisation by the people subject to the hazard. Specialists can engage to assess and collect the premiums, to assume the obligations arising out of the losses and to undertake the whole work of administration."

" It is important to realise that the cost of effecting insurance through outside parties need be no more than under a scheme of communal pooling. If the statistics provided a completely accurate basis for ***'a priori'*** calculation- and they can never do that – the premiums would be fined down until they were sufficient only to cover the losses plus the expenses of administration. This would obtain given competition for the business between the outside parties, whose remuneration would be confined to the market earnings of administration." " Some general principles for determining an insurable interest can now be laid down: (1) the risk should be real and the insured should not benefit by the claim; (2) both the amount and degree of the risk should be capable of measurement or estimation; (3) the risk should be sufficiently small and frequent to permit pooling by the transferee but not so small and frequent as to justify pooling by the transferer. A housewife, to say nothing of a hotel, need not insure teacups against breakages. An insurance company will shrink from covering the hazards of a modern war; (4) the risk should not be too much dependent on the actions of the insured. The personal hazard, as it is known, is well exemplified by automobile insurance. The difficulties of this business are only kept within bounds by the deterrent risks of death or criminal prosecution involving the insuring person himself.

" Of these principles a large number of the hazards in both private and business life are covered by the device of insurance, operating by the method of consolidation. The offsetting of gains and losses effected by the consolidation of cases even permits the use of insurance when the statistical basis for the computation of rates is defficient and when there is no discoverable kinship among the cases themselves."(2)

2. ***Chamber's Encyclopaedia,*** vol.7–p. 608–9.

The principle can be illustrated by a simple example of fire insurance. There a community, which has 1000 houses, each valued at £20,000, and each exposed to more or less the same probability of destruction by fire. There is extremely remote probability that any one of these houses will be destroyed by fire in any particular year; and if it occurs, it cannot be more than one out of 1000. But whoever suffers the destruction has suffered a large loss of £20,000. If all the owners of houses combine to contribute £20 per head, will provide a large fund to repay in full the cost of the burned house to its owner. Thus each house's owner can protect himself from the probable loss of £20,000 by contributing a small amount of £20.

In actual practice, only a small percentage of the houses will be destroyed by fire, and the house-owners can easily eliminate this danger to their property by joining together and contributing willingly small annual instalments to a mutual indemnity fund. The principle of loss sharing can be applied likewise to any other form of risk to which man is exposed in the modern world. (3)

11. CLASSIFICATION OF MODERN INSURANCE CONTRACTS

Contracts of insurance – can be classified in three ways. (4)

(1) According to the nature of the event which leads to the payment of compensation.

(2) According to the nature of the interest which is supposed to be affected.

(3) According to the nature of insurance.

1. THE NATURE OF THE EVENT

There are four major classes of insurance according to the nature of the event:

(a) **Marine Insurance**: In this class of insurance the insured amount becomes payable on the occurrance of the marine incident .

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3. McGill, Dan M., Illinois, 1967–op. cit., p.26.
4. Ivamy Hardy E.R., ***General principles of Insurance Law,*** London, 1970, P.6–8.

(b) **Fire Insurance**: In this insurance the insured amount becomes payable on the occurrence of a fire.

(c) **Life Insurance**: In this insurance the insured amount becomes payable on the death of the insured person.

(d) **Accident Insurance**: In this class of insurance, the insured amount becomes payable on the occurrance of any other event.

It can, however, be pointed out that this distinction between the various classes of insurance is only conventional and it may change with the change in the needs of the people. As a matter of necessity or convenience, or mere business insurance may offer protection against any particular danger, e.g., burglary, car accident, livestock peril, damage to property, etc.

2. THE NATURE OF THE INTEREST AFFECTED

There are three forms of insurance according to the nature of the interest affected:–

(a) **Personal Insurance**: In this form of insurance, the event affects the insured person himself, or a third party. This includes life insurance, sickness insurance and personal accident insurance.

(b) **Property Insurance**: This type of insurance affects the property of the insured, e.g., fire insurance, marine insurance, burglary insurance etc.

(c) **Liability Insurance**: This type of insurance places a liability upon the insured person towards a third party. This insurance consists of (i) public liability insurance, with regard to vehicles; and (ii) employers' liability insurance.

3. THE NATURE OF THE INSURANCE (4)

There are two types of insurance according to the nature of the insurance:

(a)OTHER THAN INDEMNITY CONTRACT:In this type of insurance the sum

insured becomes payable on the happening of a specified event. It has ... relation to the extent of the loss of the insured person. It comprises ... insurance, personal accident insurance and sickness insurance.

(b) **Contracts of Indemnity**: In this type of insurance, the sum payable ... determined by the extent of the losses of the insured person, for example ... marine insurance. The loss actually suffered by the insured person determines ... the amount of the indemnity to be paid to the insured person, if the amount ... loss or damage to be paid is not specified. The Marine Insurance Act 1906 (British) states that : " A contract of marine insurance is a contract whereby ... the insurer undertakes to indemnity the assured, in the manner and to the ... extent thereby agreed, against marine losses, that is to say, the losses incidental ... to marine adventure." (4)

(iii). FUNCTION OF INSURANCE

In general, the functions of insurance can be classified as primary and ... secondary:

(1) Primary Functions

The primary function of insurance is to provide security for the individual ... against certain dangers so that his financial losses are equitably distributed over a ... large number of people. His risks are assessed and amount of his contribution ... spread over a number of years.

(2) Secondary Functions

Insurance has enabled commercial, industrial and a vast number of other ... business organisations to operate on a large scale which otherwise would have ... been impossible.

(3) Indirect Functions

Huge insurance funds are invested in Government securities and mixed ... shares which indirectly provide financial assistance to the Government and ... authorities and industry.(5)

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5. Dinsdale, W. A., *Elements of Insurance*, London, p. 2 , 1965

IV. THE NATURE OF THE INSURANCE CONTRACT

In studying the nature of the insurance contract a clear distinction must be made between the subject-matter of the insurance contract and the subject-matter of insurance.

(1) The Subject-Matter of the Insurance Contract

It must be borne in mind that a contract of insurance can only secure an amount of money for the insured on the happening of an accident. It cannot prevent an accident from happening. Therefore, the subject-matter of the contract of insurance is, in fact, money, whereas the subject-matter of insurance is independent of the contract and must be distinguished from it. (6)

" Now, in my judgement, the subject-matter of the contract of insurance is money, and money only. The subject-matter of insurance is a different thing from the subject-matter of the contract of insurance... The only result in the policy, if an accident which is within the insurance happens, is a payment of money. It is true that under certain circumstances in a fire policy, there may be an option to spend the money in rebuilding the premises, but that does not alter the fact that the only liability of the insurance company is to pay money. (6)

(2) The Subject-Matter of Insurance

The subject-matter of insurance may be:

(a) a physical object; (b) a debt or chose-in-action, or
(c) a liability imposed upon the insured.

a) A PHYSICAL OBJECT

The subject-matter of insurance in fire insurance, burglary insurance and personal accident insurance is the building, the property or the body of the insured person respectively.

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6. Irony Hartley, E.R., op. cit., p.10–11.

insured becomes payable on the happening of a specified event. It has ... relation to the extent of the loss of the insured person. It comprises ... insurance, personal accident insurance and sickness insurance.

(b) **Contracts of Indemnity**: In this type of insurance, the sum payable ... determined by the extent of the losses of the insured person, for exam... marine insurance. The loss actually suffered by the insured person determ... the amount of the indemnity to be paid to the insured person, if the amount ... loss or damage to be paid is not specified. The Marine Insurance Act 19... (British) states that : " A contract of marine insurance is a contract where... the insurer undertakes to indemnity the assured, in the manner and to ... extent thereby agreed, against marine losses, that is to say, the losses incide... to marine adventure." (4)

(iii). FUNCTION OF INSURANCE

In general, the functions of insurance can be classified as primary ... secondary:

(1) Primary Functions

The primary function of insurance is to provide security for the individu... against certain dangers so that his financial losses are equitably distributed ov... large number of people. His risks are assessed and amount of his contributio... spread over a number of years.

(2) Secondary Functions

Insurance has enabled commercial, industrial and a vast number of othe... business organisations to operate on a large scale which otherwise would hav... been impossible.

(3) Indirect Functions

Huge insurance funds are invested in Government securities and industri... shares which indirectly provide financial assistance to the Government, loca... authorities and industry.(5)

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5. Dinsdale, W.A., ***Elements of Insurance,*** London, p.2 , 1965

IV. THE NATURE OF THE INSURANCE CONTRACT

In studying the nature of the insurance contract a clear distinction must be made between the subject-matter of the insurance contract and the subject-matter of insurance.

(1) The Subject-Matter of the Insurance Contract

It must be borne in mind that a contract of insurance can only secure an amount of money for the insured on the happening of an accident. It cannot prevent an accident from happening. Therefore, the subject-matter of the contract of insurance is, in fact, money, whereas the subject-matter of insurance is independent of the contract and must be distinguished from it. (6)

" Now, in my judgement, the subject-matter of the contract of insurance is money, and money only. The subject-matter of insurance is a different thing from the subject-matter of the contract of insurance... The only result in the policy, if an accident which is within the insurance happens, is a payment of money. It is true that under certain circumstances in a fire policy, there may be an option to spend the money in rebuilding the premises, but that does not alter the fact that the only liability of the insurance company is to pay money. (6)

(2) The Subject-Matter of Insurance

The subject-matter of insurance may be:

(a) a physical object; (b) a debt or chose-in-action, or
(c) a liability imposed upon the insured.

a) A PHYSICAL OBJECT

The subject-matter of insurance in fire insurance, burglary insurance and personal accident insurance is the building, the property or the body of the insured person respectively.

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6. Ivamy Hardly, E.R. op. cit., p.10–11.

(b) **A Debt or Chose-in-Action**

The subject-matter of insurance in solvency insurance is the debt, chose-in-action against the loss of which the insured person seeks protection

(c) **A Liability Imposed Upon the Insured**

The insured has neither any direct interest in the safety of third parties or the protection of their property, nor is he seeking protection against through injury or damage in the accident. What he seeks to insure against is consequence of an action for which he happens to be responsible. This liability insurance, wherein the insured seeks protection against liability third parties, the liability insured against is the subject-matter of insurance.

(3) Description of the Subject-Matter

It is desirable to have a description of the subject-matter of insurance in order

(a) to identify the subject-matter;
(b) to show the nature of the risk; and
(c) to define the risk.

(a) **Identification of the Subject-Matter**

It is necessary to have a clear description of the subject-matter of insurance its identification. It forms part of every policy of insurance. " A description of the subject-matter of the insurance is required both from the nature of the contract and from the universal practice of insurers... If property which answers the description of the policy be at risk, the policy will not attach, the assured may have other property at risk of equal or greater value. The reason being that the assurers have not entered into a contract to identify the assured from any loss on the property." The description may be (i) specific, or (ii) general.

(i) Specific Description: The specific description applies to only one object and can be easily identified in case of accident.

(ii) General Description: This is a description of the subject-matter in general

7. Ivamy Hardy, E.R., op. cit., pp.12–17.

terms applicable to any object within a particular class. The policy in this category of insurance is intended to cover any object within the particular class.

It is therefore the duty of the insured to give in good-faith an accurate description of the subject-matter because the insurers generally accept the risk according to the description of the subject-matter by the insured. It is probable that the subject-matter of insurance may undergo alteration, or other changes during the course of time which may destroy the identity of the subject-matter. It is therefore necessary and desirable that some reference must be made to the description in the policy which defines the subject-matter in order to avoid any confusion later on. (7)

(b) **Showing the Nature of the Risk**

The insurer naturally accept the risk by the description of the subject-matter given by the insured. It is therefore, required for the insured to give an accurate description. (7)

(c) **Defining the Risk**

The subject-matter of insurance may undergo changes during the currency of the policy and affect the validity of the policy or of the claim. Therefore, in order to determine whether any change has occurred, reference has to be made to the description in the policy, which provides the standard by defining the subject-matter at the time of the inception of the insurance. (7)

V. INSURABLE INTEREST

The subject of insurable interest is of enormous significance, especially for fire insurance, life insurance and marine insurance, wherein it may lead to many complications. Therefore, the following problems regarding insurable interest must be thoroughly examined and clarified in every contract of insurance.

1. **What Constitutes an Insurable Interest**

J.Lawrence has defined insurable interest in the following words: " A man is

interested in a thing to whom advantage may arise or prejudice happen from circumstances which may attend it– and whom it importeth that its condition safety or other quality should continue: interest does not necessarily imply right of the whole or a part of a thing, nor necessarily and exclusively that may subject of privation, by having some relation to, or concern in the subject of the insurance, which relation or concern by the happening of the peril insured against may be so affected as to produce a damage, detriment, or prejudice to the person insuring; and where a man is so circumstanced with respect to matters exposed to certain risks or damages, or to have a moral certainty of advantage or benefit, but for those risks or dangers, he may be said to be interested in the safety of a thing. To be interested in the preservation of a thing, is to be so circumstanced with respect to it as to have benefit from its existence, prejudice from its destruction. The property of a thing and interest devisable from it may be very different; of the first price is generally the measure, but by interest in a thing every benefit or advantage arising out of or depending on such thing may be considered as being comprehended.(8);

This defination is the basis of the marine insurance Act of 1906, which states " In particular, a person is interested in a marine adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss or damage thereto, or by the detention thereof, or may incur liability in respect thereof."(9)

When the subject-matter of insurance is physical object which is exposed to danger, as is in the case of personal accidents, or property insurance, the insurable interest is clearly established. But, when the subject-matter is not a physical object, as in case of liability insurance, the insurable interest is not so apparent and therefore, it must be clearly established. In this case the insured is likely to suffer damage by the occurence of an event. Therefore, he has an insurable interest in the event. Furthermore, insurable interest must have material value and must be real, for the mere expectation of acquiring an interest is not enough to make it insurable. So long as it is real, it is insurable even if it is a future interest.(9)

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8. Ivamy Hardy, E.R. op. cit., p.18–19
9. Ivamy Hardy, E.R. op. cit., p.20–28

2. Necessity for an Insurance Intrest

Every contract of insurance to be valid must be supported by an insurable interest, e.g. in personal accidents, the safety of the person constitutes the insurable interest and in property insurance, the insurable interest is in the property. If a person has no insurable interest in any property or goods, or person, he will not suffer any loss by damage to any of them, therefore such a contract will not be valid.

3. Discription of Interest

(a) General Rule

In spite of the fact that an insurable interest in the subject-matter is essential, it is not necessary to mention it in the contract; but sufficient description of the subject-matter must be given to show the interest of the insured in it. (10)

(b) Exceptions to the General Rule

There are certain exceptions to the general rule described above and a specific description of the interest of the insured is necessary in these cases: (i) Where there is a specific condition requiring description of the interest. (ii) Where prospective profit or consequential loss are the subject of insurance. (iii) Where the interest, because of its precarious nature, is material to the risk. (11)

4. Time for Insurance Interest

(a) Interest at time of the loss sometimes essential

(i) INTEREST OTHER THAN LIFE INSURANCE: The insured must have an insurable interest in the object at the time of the loss, because he cannot claim any indemnity for having no interest for he could not have suffered any loss. (ii) Life Insurance: The insured is required to have an insurable interest at the time of the insurance.

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10. Ivamy, op. cit., pp. 79-80.
11. Ivamy, op. cit., pp. 105-107.

(b) Retrospective Insurance

Even if the object is destroyed, the insurance contract will be valid, if the insured can show that he had interest in the object at the time of its loss. Thus there is no objection to a retrospective insurance if the interest existed at the time of the accident. Such a contract can be valid on two conditions: (9) That both the insured and the insurer had no knowledge of the loss at the time of contract; and (ii) That both wanted the contract to cover such a loss. The intention of the parties must be clearly visible, though not in words, in the language of the contract. (10)

V1. THE MAKING OF THE CONTRACT

It is necessary to have a clear agreement in corporating the main features of a contract. The parties must have agreed, the insurer agreeing to insure a specific person, and the insured agreeing to the specific insurance. They must also fix the period of insurance, and must agree to the amount to be insured and the premium to be paid. Finally, the contract must have been agreed between the parties, an offer ot agreeing to enter into the contract on the part of one party, and an acceptance of the offer on the part of the other. (10)

No party can withdraw from the contract after accepting it. It is binding on the insured to pay the premium and on the insurer to accept the premium and pay any sum when it becomes, payable. However the parties can withdraw by mutual consent.

V11. THE PRINCIPLE OF GOOD FAITH

The insured is required to state all facts accurately and in good faith. The rule of good faith was set by Lord Mansfield in the following words:
"Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie more commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge , to mislead the underwriter into a belief that the circumstance does

12. Ivamy, op. cit., p. 108

not exist, and to induce him to estimate the risk as if it did not exist. The keeping back of such a circumstance is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the underwriter is deceived, and the policy is void; because the risk run is really different from the risk understood and intended to be run at the time of the agreement. . . The governing principle is applicable to all contracts and dealing. Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary." (11)

V111. THE EXTENT OF THE INSURED'S DUTY

The insuree must disclose all facts which are known to him. He must not make any misrepresentation with regard to any facts. All facts known to him must be disclosed, and he cannot escape the consequences of not revealing them by saying that he did not know. Failure to do so will render the contract voidable. (12) The onus of proof that the insured has misrepresented the facts or broken certain conditions with regard to the disclosure of facts lies upon the insurer.(13)

1X. THE PREMIUM

The amount of the premium to be paid by the insured is a matter of contract and depends on the estimate of the risk involved as calculated by the insurer. As soon as the contract is completed the insured becomes bound to pay the premium and the insurer becomes liable to pay compensation. The acceptance of the premium by the insurer is an indication that the contract of insurance is completed. (14)

X. THE POLICY

Policies can be clsssified on the basis of the description of the subject-matter or the sum payable on loss.The rights of the parties are determined by the terms of the policy formulated by the insurer.The commencement and the duration of the policy is also specified,but a policy may be brought to an end by the

13. Ivamy

mutual consent of the parties. (15)

The policy also contains a description of the event insured against, and possible exception under which the insurer will not be held responsible. also contains conditions on which the validity of the policy depends. (15)

(a) Classification of Policies

There are two types of policies under this catagory. (i) There are policies which the subject-matter is very accurately and precisely defined leaving doubt about the object of the insurance, e.g. personal accident insurance, insurance of specific properties. (ii) There are policies in which subject-matter is defined in general terms and the insurance policy can applicable to any object within that class, e.g., insurance of property in gen or insurance against public liability. (16)

(b) Classification of Policies according to the Amount Payable

There are two types of policies under this class;

(i) Unvalued Policies. The amount payable to the insured is not specified the policy but is determined after the event has happened. (16)

(ii) Valued Policies. The amount payable is fixed by the policy. In all person accident policies, the recoverable amount is fixed. (16)

(c) The Perils Insured Against in the Policy

Any peril, which the insured seeks to insure against and the insurer is willing accept, can be insured. The perils differ according to the class of insurance, b in all cases reference is always made to the description in the policy in order find out the peril insured against. It is, therefore, absolutely necessary that th description of the policy must be made with great accuracy and precision.(17)

14. Ivamy, op. cit., pp. 164-71.
15. Ivamy, op. cit., pp. 191-92.
16. Ivamy, op. cit., pp. 193-94.

(d) The Conduct of the Insured

Any wilful act on the part of the insured which causes the peril insured against to happen, exempts the insurer from his liability. The breach of good faith rather than the misconduct of the insured is more important in finding the ground of the exemption.(18)

(e) The Conditions of the Policy

Every policy insurance contains terms and conditions which determine the validity of the policy. (19)

X1. THE CLAIM

The insured is entitled to enforce the policy when the event insured against actually happens. The loss must be caused by the event insured against and a loss not caused by the peril does not come under the policy. (20)

X11. BURDEN OF THE PROOF

It is the duty of the insured to prove that loss is caused by the peril insured against but he is not required to prove the cause of the loss with absolute certainty. His duty is only to establish a ***'prima facie'*** case. (21)

17. Ivamy,op. cit., pp.
18. Ivamy, op. cit., pp. 246-47.
19. Ivamy, op. cit., pp. 251-52.
20. Ivamy,op. cit., p. 351.
21. Ivamy, op. cit., pp. 389-91

6

ANALYSIS OF THE MODERN INSURANCE CONTRACT

1. INTRODUCTION:

It is said that the modern contract of insurance is based on the usu... marine loans of the ancient Greeks. The ancient Greeks advanced loans o... ship or its cargo at a very high rate of interest which included, in additio... the payment for the use of money, the charge for the risk of losing it. T... high premium in the form of a high rate of interest was demanded from ... skipper partly for use as capital and partly to cover the risk of loss of ca... Thus every contract of marine loan in the ancient Greek contained ... element of interest. The rate of such marine loans was much higher than ... normal current rate of interest in the country.

" Money was advanced on a ship or cargo, to be paid with large interest ... the voyage prospered but not repaid at all if the ship be lost, the rate ... interest being made high enough to pay not only for the use of the capit... but for the risk of losing it." (1)

And, according to ***Chambers' Encyclopaedia*** , " The insurance element ... the Greek loans was formed in the provision that if the security upon wh... the money was advanced was lost or destroyed, then the debt was cancelled. For example, if a cargo of grain was to be shipped from one port to another ... the owner of the grain would borrow its value at a rate in excess of th... current rate of interest. Then, in event of loss, the money lender had t... bear the burden and the owner of the grain was not required to repay th... loan." (2)

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1. ***Encyclopaedia Britannica,*** Insurance, vol.14., p.657.
2. ***Chambers' Encyclopaedia*** · Vol. 13, p.61, Insurance.

2. MODERN INSURANCE CONTRACTS

The purpose of all insurance is to seek protection against all kinds of risks to which man is exposed. The insured tries to shift the burden of the probable loss on to the shoulders of others, who are prepared to take the risk for some financial gains to themselves. All those agencies which do insurance business and bear risks have found through experience in general, and mathematical calculation in particular, that they will make a reasonable profit after meeting such incidental expenses.

All insurance contracts are made on the principle of uncertainty, uncertain events which involve speculation as well as risk. Both the insurer and the insured enter into a contract of mutual risk, the former risking a loss and the latter risking his premiums.

All contracts of insurance are embodied in a formal document, called a policy (Life Assurance Act, 1774) which the insurer is legally bound to issue to the assured on the receipt of the premium and failure to do so will render him liable to a fine. (The stamp Act, 1891). The policy is issued by the insurer when the proposal is accepted and it contains all the terms of the contract.

(a) **The Premium**: The premium is the price at which the insurer is prepared to take risks and bear the burden of the probable loss involved in the contract of insurance. On the basis of the law of averages, the insurer finds through experience a reasonable amount sufficient to cover his risk as well as other charges, including his profits, and fixes his premium to be recovered from the assured. Once the premium is paid and risk accepted by the insurer, it is not returnable.

The main factors which influence the determining of the premium are the claims, commission, and profit. The size of profits from the investment of the accumulated funds of the insurance companies can also play an important part in determining the rate of premiums.

The contract of insurance becomes effective only when the premium is paid

by the assured and received by the insurer. The premiums are normally pa by a certain specified date each month (or each week); both the amount premium and the date of its payment are clearly expressed in the poli The policy remains in force during the period of its duration, unless allow to lapse by non-payment of the subsequent instalments of the premium their due date, or within the ' days of grace ' allowed for the payment of premiums. Normally a loss occurring during the days of grace is covered the instalment due is paid before the expiry of the days of grace. (3)

Once the premium is paid by the assured and risk assumed by the insurer, is not recoverable under a valid and legal policy. " Once the premium is pa and risk assumed by the insurer, there shall be no apportionment or retu of premium afterwards, even though the subject-matter of the risk may vanish before the period of cover has elapsed. " (4) And again, " the ris taken is entire, if it has once attached, no apportionment of premium is possible even if the policy subsequently becomes forfeited." (5)

In fact, in many cases the assured, owing to their ignorance of the insurance law, or their inability to continue with the policy, fail to recover even par of the premium. The failure of consideration is attributed in most cases to the conduct of the assured because of their lack of knowledge of insurance law and, consequently, they have to forfeit whole or part of their premium.

Further, there are many lapses and surrenders of policies by the assured for many reasons beyond their control, and in all such cases, they are the losers because they are unable to recover the major part of their premiums. Again, a close study of British insurance shows how the insurance companies arbitrarily fix premiums and charge varying rates for different people. In most of the cases relating to commercial insurance, it is impossible to find any scientific, or even quantative relationships between the premium and risk against which insurance is required. Above all, there is no scientific or

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3. Ivamy, op. cit., p.168.

4. Cheshire, G.C., and Fifoot, C.H.S., *The Law of Contract*, London 1964–p.497.

5. Preston, S., and Colinvaux, R.P. *The Law of Insurance* ,London 1939–p.122.

rational method of determining the amount of premium relative to the risk involved, especially in life assurance, and the commercial insurance companies adopt their own arbitrary ways of fixing premiums for each category of insurance. As such, the premiums charged from the assured are most likely to contain elements of profiteering, exploitation and even wagering.

(b) Indemnity

Indemnity signifies protection against loss, and it therefore reflects the intention of the insured to secure himself against such a loss without seeking any profit from it.

Every contract of insurance is normally a contract of indemnity because it insures a compensation for loss to the insured; but the insured must not be allowed to make a profit out of it. He will be able to recover his loss but not more, unless previously agreed otherwise between the parties. If any one is not adequately insured, his insurers are not expected to repay him above the limit of the amount insured. This principle is clearly stated by L.J. Brett, " The very foundation, in my opinion, on every rule which has been applied to insurance law is this, namely, that the contract of insurance contained in a marine or fire policy (and that equally applies to accident policies) is a contract of indemnity alone, and that this contract means that the assured, in a case of loss against which the policy has been made, shall be fully indemnified, but shall never be more than fully indemnified. That is the fundamental principle of insurance, and if ever a proposition is brought forward which is at variance with it, that is to say, which either will prevent the assured from attaining a full indemnity, or which will give the assured more than a full indemnity, that proposition must certainly be wrong."(6)

There are certain kinds of contracts of insurance, e.g., life and personal accidents insurance, which are not contracts of indemnity, for in all such cases, the insurer has to pay compensation on the happening of an event without reference to loss.

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6. Dinsdale, W.A., ***Principles and Practice of Accident Insurance*** London 1969–p.34.

The operation of the principle can be shown by considering a comprehen... motor policy. " The insured estimates in advance the value of his car at, s... £1,000 and pays a premium accordingly. If his car is totally destroyed by ... he will not, however, automatically recover £1,000. It may be that ... over-valued the car at the outset, or that the market value of cars has fall... during the period of insurance. What the insurers will pay will be the valu... the car at the time of its destruction, and if they can show that at that ti... car of similar age, make, type, and condition could be bought for £750, sh... will not be liable to pay more than £750. With a cheque for £750, the insu... will be fully indemnified. The same principle applies to a partial loss." (7)

(c) Limits of Indemnity

There is practically no limit to the amount of damages that may be claimed b... the insured under a policy of indemnity unless the policy is a ' valued ' or ... agreed value ' one, in which case the sum insured is the measure of indemn... and, under no circumstances, can payment exceed this limit. " Under a poli... of this kind, the sum insured is deemed to be the value of the proper... throughout the currency of the insurance and the sum insured is paid with... any adjustment for total loss of any of the items– valued policies appear to b... contrary to the principle of indemnity but, legally, it is held that the parti... agree the measure of indemnity at inception of the contract, instead of wait... to assess the amount of pecuniary loss after the insured event has taken pla... and given rise to a claim."

Further, " it is necessary to distinguish ' agreed value ' or ' valued ' policie... from those which are made subject to the usual " inventory and valuation " ... clause – which is accepted as evidence of the value of the property on the da... of valuation – subject to reasonable allowance for depreciation or appreciati... at the date of loss, within the limits of the sum insured."(8)

(ii) Real Significance of Indemnity

A scrutiny of the insurance contract and the principle of indemnity shows tha... it is partly based on the concept of usury and interest; partly on th... indeterminate character of risk; and partly on the element of wagering which i...

7. Dinsdale, op. cit., p.46.
8. Dinsdale, op. cit., p.46.

clearly reflected in the character of risk.

According to the principle of indemnity, the assured is entitled to compensation to the limit of his loss and no more. He cannot receive any sum of money from the insurer more than the value of his loss under any circumstances, but in actual practice the insured, in many cases, never gets full compensation of his loss. Thus, it is neither a general principle nor an established practice in insurance, especially in ' valued ' policies, that the insured can do, in ' valued ' policies recover more than their loss. " Contracts of life insurance, however, are, as we shall see hereafter, no contracts of indemnity, they are contracts to pay a specified sum on a certain event. Even contracts of marine insurance are not always contracts of perfect indemnity; the assured may recover more or less than the sum which would actually compensate him."

Thus, under a valued policy, that is , when the value of the thing insured has been agreed on between the parties, if there has been a total loss of the thing insured, the assured, if fully insured, recovers the sum agreed upon, which may be, and often is, in excess of the true value of the thing lost. On the other hand, the value of the thing lost may be in excess of the agreed value, yet the assured does not recover more than the sum in respect of which he has caused himself to be insured and has paid a premium." (9)

Thus, there is every possibility that, in such policies, the general rule of insurance, i.e. that it should be a contract of indemnity, will be violated as pointed out by M.R.Emanuel, " it is clear that, under a valued policy, the assured may, in fact, recover more than his actual loss, and to that extent the rule is violated that an insurance is a contract of indemnity." (10)

The parties in the contract of insurance can defeat the very object of the principle of indemnity by settling the value of the insured subject at the time of the contract. In all such cases, the insurance policy is only partially a contract of indemnity. Some insured, as in the case of ' valued ' policies, will

9. Gutteridge, H.C. (ed), Smith, ***Mercantile Law,*** London, 1931,p.406–7.
10. Emanuel, M.R., ***Insurance Law, Theory and Practice,*** London 1931–p.41.

receive more than their loss; while others, in 'valued' policies, will receive [illegible] than the actual value of their loss.

The supporters of insurance argue that this does not in any way infringe [illegible] basic principle of indemnity because the parties have agreed only to fix [illegible] amount of indemnity before rather than after the occurrence of loss. "It may [illegible] argued that the principle of indemnity is not infringed and that all the [illegible] does is to agree at the outset, rather than after a loss occurs, what the measure [illegible] indemnity is to be.(11)

Obviously, it is not true that the principle of indemnity is not infringed. [illegible] insurer is fixing something which does not exist at present and there is [illegible] scientific method of determining the magnitude or otherwise of that loss. [illegible] other words, he is trying to determine what is indeterminate at present, substituting uncertainty with certainty. This, is a clear violation of the principle of indemnity.

Again, in cantracts of insurance for life and other personal accident, the principle of indemnity is violated whenever either of the parties receive more or less than their due share of compensation.

Furthermore, the particular event, against which insurance is required, is itself of very uncertain nature. If the event happens, it may bring pecuniary benefit or compesation for the insured of more than his actual loss, and if it does not occur, it will earn premiums for the insurer for nothing. As such, a contract of insurance is no different from a wager, in which either of the parties promises to pay a sum of money or its equivalent to the other on the result of an uncertain event.

Finally, there are many complications and injustices in the system of 'average' in marine and non-marine insurance. In non-marine property insurance, the insurer try to insert certain conditions in the policy to make the insured seek cover for the full or near full value of the property at risk. Such conditions may operate

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11. Cockerell, H.A.L., ***Insurance, Teach Yourself Books,*** London, 1967, p.19

very unjustly for certain types of property, especially where values are liable to great fluctuations. Insurance of growing crops and other farming products by the farmers are obvious examples of this type.(12)

Thus it is manifestly clear that the claim that a contract of insurance is a contract of indemnity, is not true. It is merely a simple contract of business between two parties, the insurer and the insured. The former agrees in return for a premium to pay to the latter an agreed amount of money on the happening of an event which is of an uncertain nature. The amount of money received by the insured may be more or less than the value of his actual loss. On the other hand, if the event does not happen at all, the insurer earns the premium merely for an uncertain event. In other words, a contract of insurance is an ordinary agreement between two parties who agree to pay each other a certain sum of money on the happening of an uncertain event. Thus the whole deal of compensation in return for premium between the insurer and insured is dependent on one uncertain occurrence and this amounts to wagering or gambling.(13)

(c) Insurable Interest

Many people find it hard to differentiate between insurance and gambling because they look alike. "The outsider is struck by the seeming similiarity between insurance and gambling. The racegoer, he points out, pays a sum of money to a bookmaker, who promises in return to pay a larger sum if a specified horse wins the race. How, he asks, does the bookmaker's action differ from that of the insurer who receives a premium for the insurance of a house against fire, and who promises to pay a larger sum if the house should be destroyed or damaged? The short answer is that insurance differs from gambling because insurances can be granted only where there exists an insurable interest; that is to say, the insured must have an interest in the preservation of the thing insured, so that he will suffer financially on the happe ning of the peril insured against. Insurance without such an interest would be a mere wager and as such, unenforceable at law."(14)

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12. Cockerell, op. cit., p.23
13. ***Halsbury's Statutes of England,*** London, 1949, Vol.13, p.17
14. Cockerell, op. cit., p.3

This basic distinction was not appreciated in the past when there were no legal restrictions on gambling or wagering in English law. It was common for people to insure the lives of political figures to bet on the Prime Minister or any other famous personality and "under the Common Law the court could enforce a wager on the duration of a human life; and insurance societies did not refuse to issue policies to persons who had no interest in the lives to be insured." (15) It was not uncommon for insurance societies to issue insurance on lives and other events, in which the assured had no interest, and this led very often to undesirable gambling and hideous forms of wagering in the insurance business.

The Life Assurance Act, 1774, was passed to stop such malpractices in the field of insurance. This Act emphasises the importance of insurable interest in the contract of insurance, but fails to define the nature and extent of insurable interest. In addition, it does not cover some important fields where wagering and gambling by mischievous persons may occur. "This Act covers all insurance other than those on ships, goods or merchandises, that is, other than marine insurances and insurance on chattels. Whatever the real intention of the legislature may have been the exception of insurance on goods or merchandises was construed as extending to insurances on all chattels whether against sea or land risks, and therefore the passing of this statute still left insurance on chattels and against land risks subject only to the common law and accordingly still unfettered by any prohibition against wagering transactions or any stipulation as to the insertion of the names of the person or persons interested. Money in a form in which they can physically be burned or asporated are "goods" within the meaning of the Act, and a policy insuring against loss of such money by burglary and house breaking is not within the Act."

"Where the main subject-matter of insurance is a chattel, the whole contract of insurance is outside the Act and so in a motor-car policy it was held that the Act had no application even to the insurance against third party risk which was incidental to the insurance of the car." (16)

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15. Holder, E.A., ***Houseman's Law of Life Assurance,*** London, 1966- p.16
16. I MacGillivary, E.J.and Denis Browne, ***Insurance Law*** – London, 1953 Para 431-432.

(i) NATURE OF INTEREST. It is argued that the insurable interest must be of a material nature because compensation provided by the insurance policy is a monetary payment. This line of argument fails to explain how to determine the value of human life or other such interests which are not capable of valuation in terms of money."Most life assurances are made by persons on their own lives where the insurable interest is higher than a pecuniary interest and is not capable of valuation. Furthermore, insurances are made by persons on the life of a husband or wife ,where the insurable interet is far higher than monetary interest and is not capable of valuation in monetary terms. In all such cases,there is hardly any basis of valuation of the subject-matter, but still the insurance policies are issued on the basis of indeterminate insurable interest." (17)

Again, the Act does not take cognizance of many real and legal obligations which may have insurable interest. In the words of Breston, "profits which might be exceedingly difficult to calculate are commonly insured by valued policies. And legal obligations, such as the obligations of a wife towards her husband, may give an insurable interest in the life of another - - although they cannot be strictly described as "pecuniary". Nor can the unlimited interest of a man in his own life be so described. Again, it has been said that it is not necessary that pecuniary loss must follow from the event insured against; it is sufficient that such loss might follow. In short, pecuniary loss affords a most unsatisfactory test as to the existence of an insurable interest." (18)

A man has unlimited interest in the life of his wife, and a woman in the life of her husband. Likewise, there are many other cases where the court is not likely to limit the indemnity. For example, when a policy is affected by a creditor, he may claim under the policy, and , in addition, receive payment from the executors of the debtor. Thus, the amount of a policy affected by a creditor may cover not only the debt, but also the premiums of the policy and interest for the period equivalent to the expectation of the life of the debtor. (19)

This is considered equivalent to making profit out of the death by M.P.Picardo, "though it was at one time held otherwise, it is now immaterial that the debt

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17. Holder, op. cit., p. 27. 18. Holder, op. cit., pp.27–28
19. Houseman, D., ***The Law of Life Assurance,*** London, 1937. p. 16.

has been repaid before the death. If the interest existed at the time of [illegible] out of the policy, then the insurance is valid and the creditor can, on the dropping of the life, recover from the insurers the amount of the [illegible] money, thus making a profit out of the death."

This shows how under the existing law, one can recover a sum greater than the amount or value of the interest of the assured even though the insurable interest has ceased to exist. (21) Further, "in the case of life policies, on the lives of third parties, it would be quite possible to transact life insurance by way of indemnity. Apart from express agreement, however, a life insurance policy is not a contract of indemnity; and if there is a good insurable interest at the time of the contract, the policy remains valid although the insurable interest has ceased before the time of claim. "This is confirmed by the case of Dalby V. India and London Life Assurance Co. (1854), 15 C.B. 365. "The Anchor Life office, having issued a policy of £3,000. reassured for £1,000 with the India and London Life office. The principal policy was surrendered, but the Anchor continued the reassurance. The reassuring office resisted a claim on the ground of lack of insurable interest. It was held, that the Life Assurance Act, 1774, required an interest only at the date of the contract and that the policy was valid." (21)

Another interesting example is the insurable interest in the life of two engaged persons, a man and his fiancee as quoted by MacGillivary, "In as much as the action lies for breach of promise of marriage at the instance of either party to an engagement each has a pecuniary interest in the life of the other which on principle would be sufficient to support a policy of life assurance for a reasonable amount having regard to the financial prospects of the party whose life is insuranced." (22) According to the same author, in the United States of America, the established rule regarding the insurable interest "seems to be that if there is a *de facto* state of dependence, the dependant has an insurable interest in the life of the person who supports him even though he has no legal claim to be supported." (22) More surprising, it seems when we find that, "there are decisions to the effect that a woman cohabiting with and supported by a man who is not her husband has an insurable interest in his life." (22)

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20. ***Elements of Insurance Law*** - London, 1939, p. 22.
21. Holder, op. cit., p. 27.
22. MacGillicary, op. cit., para 494-495.

Although , "the Life Assurance Act 1774, provides that a policy effected without insurable interest shall be null and void, it does not impose any punishment and the making of such an insurance is not a statutory crime. It may, however, be a Common Law demeanour. Lack of insurable interest is a defence which the life office may plead in resisting a claim. The life office can, however, waive such a defence and if it does so the rights of property in the policy will be determined irrespective of the statute." (23)

(ii) Life Assurance Act 1977

Inspite of its strict provisions regarding the insurable interest, the Life Assurance Act 1774 has not been very successful in stopping wagering in the field of insurance. Once a valid insurance policy is issued to the insured, it cannot be declared invalid even if it is afterwards transferred to another person who has no interest in it. In the words of MacGillivary, "it cannot afterwards be invalidated by assignment to a person who has no interest, but takes it merely as a speculation." (24) And, this occurs also if a person acquires a strong interest in the death of another person by contract even though he has no interest in the life of that person. This shows how wagering in the guise of insurance could still be practised and the Act totally failed to stop such practices.

According to Polloch, "There is nothing to prevent any person from insuring his own life a hundred times, paying in each instance, only one premium, provided it is bona fide, an insurance on his life, and, at the time, for his benefit, and there is nothing to prevent him from dealing with such policies by assigning them to someone else, and nothing to prevent this being done, even though at the time when he effected the policies he had the intention of so dealing with them. There is no law against this, and it is not within the evil or mischief of the statute." (25)

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23. Holder, op. cit., pp. 20-21.
24. MacGillivary, op. cit., para 502.
25. MacFarlane V. ***Royal London Friendly Society*** (1886), 2 ***Time's Law Reports***, 755 quoted by Dr. Muhammad Muslehuddin, ***Insurance and Islamic Law*** - London, 1969, p. 58.

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25. MacFarlane V. ***Royal London Friendly Society*** (1886), 2 ***Time's Law Reports***, 755 quoted by Dr. Muhammad Muslehuddin, ***Insurance and Islamic Law*** - London, 1969, p. 58.

(iii) Gaming Act, 1845

The object of this Act was to stop all malpractices in the nature of wagering as insurance. The Act starts by declaring all contracts or agreements by way of gaming or wagering unlawful without defining what constitutes 'game'. And as all games are quite legal in common law, it becomes confusing to differentiate between what is lawful and what is unlawful. Our apprehension is confirmed by H.A. Street, when he says,"much of the confusion into which this branch of law has drifted is due to the absence of statutory definition. The silence of statutes has placed upon the courts the duty of defining terms and phrases, for the purpose of deciding whether the facts provided fall within their scope, so that first part of an enquiry may well necessitate review of a considerable portion of the case law relating to the whole project."(26)

Again, the practical difficulties in differentiating between a policy of insurance and wagering are very forcefully set out by the same author,"a policy of insurance is in externals hardly, if at all distinguishable from a wager. Where the contract is not one of indemnity, the mutual risk of loss and gain is apparent, and where the contract is of indemnity, the operation of the Act of 1845, if applicable, would be avoidable only in the doubtful view that the recoupment of loss does not amount to a gain. It has been stated of a contract of indemnity that four distinctions may be drawn:

(i) That the payment by the insurer is made *'qua'* indemnity; but a man who has lost his property may well regard such payment as a gain. That it at least constitutes a re-gain is undeniable;

(ii) That the event is adverse; but surely if a man bets that misfortune will befall him and suffers as anticipated, the contract remains a bet;

(iii) That the loss of premium is unaffected by the result; but this is so in coupon cases also; and

(iv) That insurance do not win the premium; but this is doubtful. Every insurance policy looks like a wager, generally renewed from year to year." (27)

Then he shifts his arguments to wagering and says " the question, however, whether a policy can be differentiated from a wager is only of academic interest.

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26. *Law of Gaming,* London, 1937 p.1 quoted by Dr. Muslehuddin op. p.59–60
27. Street, H.A. *Law of Gaming,* London, 1937 p.120–121 quoted by Dr Dr Muslehuddin, op. cit., p.60–61

It is beyond question enforceable as a contract, and not a wager within the Act of 1845. This enforceability rests ultimately on the Common Law, which treated as valid all contracts, including those of insurance, made for consideration. The only limitation was, and is, that such contracts must conform to Common Law principles, and this particular class of contract has been saved from the operation of the gaming law by insurance statutes, which, by their insistence on the said principles, have in effect, legalised or reserved the legality of, contracts conforming thereto." (28)

MacGillivary, while discussing the subject of wagering, argues that, "this Act makes void (although it does not prohibit or render illegal) all contracts which in substance are wagers made without any kind of interest in the subject-matter other than the interest which the wager creates. Insurance policies, therefore, are clearly within the Act, if made without interest, or concern in the subject-matter. It is doubtful, however, whether the Gaming Act requires any insurable interest in the strict sense in which insurable interest is required by the Acts of 1745 and 1774. The Act relates only to gaming and wagering, and there is no reference in it to insurance or insurable interest. It is clear on theauthorities of these Acts that an expectation of future benefits does not create an insurable interest within the meaning of the Insurance Act: but if the expectation is more likely to be realised than defeated, a contract to insure against its loss is not a contract by way of gaming or wagering. It is submitted that the absence of insurable interest in the strict sense does not, by itself, import the element of gaming so as to avoid the contract under the Gaming Act."(29)

The Act does not clearly define the meaning either of gaming or wagering which makes it difficult to distinguish a policy of insurance from wagering. The Act also fails to prohibit the insurance policies which in substance are wagering but can be lawfully issued in the Common Law. It is true both of the Gaming act as well as the Assurance Acts that they merely render the contracts made by way of gaming or wagering void but cannot make them illegal. Thus, those who are guilty of wagering or gaming cannot be punished under the law of the land.

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28. Street, p. 120–21 quoted by Dr. Muslehuddin, op.cit., p.60–61
29. *Insurance Law,* op. cit., para 442

Some people doubt its applicability to insurance policies. It simply refers to gaming or wagering without mentioning insurance. It is argued that contracts of insurance do not fall withing the scope of the Gaming Act of 1845. Further, the complete silence of the Act on the most significant subject of insurable interest reduces its importance in relation to the contract of insurance. This is obviously a retrogressive step from the viewpoint of the insured.

(iv) Marine Insurance Act 1906

This Act replaced the previous Acts of 1745 and 1788. The main points of criticism of this Act are:

1. The Act renders void all contracts of marine insurance entered into:
   (a) By way of gaming or wagering, or
   (b) Without interest and without expectation of acquiring interest; and
   (c) All policies made on the basis of 'policy' is the proof of interest.

But this is not enough to stop illegal business in insurance policies, unless such practices are made illegal. The Act does not make such policies illegal.

2. The Act also fails to provide a comprehensive definition of the insurable interest, to cover every aspect of insurable risk. Besides, it has other flaws with regard to the application of insurable interest to varying situations:
   (a) An expectation of acquiring a right is equivalent to an insurance interest.
   (b) A right is enough to create an insurable interest even if it is uncertain occurrence, or capable of annulment as it is based on the happening of some future event which may never happen, or dependant upon the chance of it coming into possession which may never materialise.
   (c) A partial interest of any nature is also insurable. In the words of MacGillivary," so, too, interest to the full amount of the risk insured is not required by the Gaming Act. One who has a limited interest in profits but has some concern for the safety of the whole may insure it up to the full value.(30)

30. MacGillivary, op. cit., para 442

(d) Even the change of interest does not affect the validity of the insurance policy. It allows assignment even if the assignee has no interest in the subject-matter at the date of the loss.Thus, the Act plays in the hands of the mischievous persons who are likely to use the weapon of assignment of policies to defy the law and to make profit out of wagering in insurance. Lord Mansfield has rightly said," insurance is a contract on speculation" and as such " it is frequently hard to distinguish , as regards principle, a contract to insure from an ordinary danger." (31)

On this point, MacGillivary's comments are quite appropriate." If the insurance is upon property and not upon any specified interest in it, and if there is no condition to the contrary, the fact that the value of the assured's interest change during the risk does not affect the validity of the contract. Where an owner, who had mortgaged his premisss insured them, and subsequently his equity of redemption having been sold under an execution, he was at the time of his loss in possession of the premises as tenant to the mortgagee, it was held that he was entitled to the amount insured by the policy not withstanding the change in the nature of his interest.(32)

3. As a result , the insurance companies and the underwriters have made enormous profits by issuing illegal policies and by their unlawful practices in the way of wagering or gambling in insurance. Many insurance experts have called this kind of exploitation and other malpractices in the field of insurance as " the organised swindle" of the insurance companies.

The following figures relating to policies subscribed, surrendered, lapsed and the profits made by the companies will give a rough estimate (which is just the tip of the ice-berg) of the scale of profiteering and exploitation through gambling or wagering in the civilised countries of the world.

31. Dr. Muslehuddin, op. cit., p.68
32. *Insurance Law*, op. cit., para 462

(a) The Refuge Assurance Company issued 9,322,336 policies, out of which 6,426,314 lapsed during 1909 and 1918. It seems that the majority of the policies issued during this period lapsed for one reason or another within a short space of time.(33)

The large number of lapses was revealed by B.Janner, M.P. in 1934 " during the previous fourteen years nearly 100 million policies had lapsed and the owners of them lost upwards of £100,000,000. The income of the companies concerned was £772,468,183: the management expenses and shareholders' dividends amounted to £314,981,599. But policy-holders received only £271,599,864 and the interest funds were increased to 215,000,000. The dividends to shareholders have more than doubled in this period."(34)

(b) " Out of a total of 23,500,000 policies subscribed in 1929 (in the U.S.A.), 2,441,000 were surrendered and 6,523,000 lapsed, making a total of surrenders and lapses in one year of 8,964,000. " (35) The main reason for the surrenders and lapses of about 5% of the policies was that they were unduly issued to those people who never fully understood the cost involved and their own ability to meet such cost.

The actual loss to the policy-holders was much greater than the figures show because, " this does not represent more than half of the amount lost to the policy-holders, because the agents' commission is usually not less than 50 per cent, and therefore , it can be assumed that the policy-holders lost over 100,000,000 dollars on that item alone." (35)

The growth of profits, premium incomes and the funds of the British insurance industry during the last 50 years, in spite of multifarious difficulties and two world wars, is a clear index of their prosperity; while the number of lapses, surrenders and lapses of policy-holders is an indication of their suffering. In other words, the insurance business has thrived at the cost of the policy-holders and this has been mainly through gambling or wagering in insurance companies. The growth of premium incomes, profits etc. can be seen from the tables 1–10 in the chapter on the history of British Insurance. (36)

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33. Barou, H., *Co-Operative Insurance,* London, 1936, p.53–6
34. Barou, p.57
35. Barou, p.60
36. Barou, pp.60–63

(v) General Conclusion

The series of legislative measures of the British parliament since the middle of the eighteenth century to control wagering and gambling in the insurance, though they were without much success, is a close indication that there is something fundamentally wrong in the approach of the British politicians in this matter. The main efforts have been concentrated on the principle of indemnity and the insurable interest, in order to stop profiteering and gambling in the insurance business, but the main issue, which is at the core of the evil (i.e. commercial insurance and its effects on the community), has never been brought up. Exploitation, profiteering and gambling are indispensable to commercial insurance, and unless the main defect in the insurance industry is rectified, piecemeal efforts to polish up secondary issues, will never solve the basic problem of this industry.

The persistent efforts of successive British Governments since the middle of the nineteenth century to remedy the basic weakness of commercial insurance by partially or wholly replacing it by state insurance met with severe opposition from the business-sponsored members of parliament and ended in a compromise which was the form of the Friendly Societies Act of 1875 which " provided facilities for the formation of friendly societies and laid down rules for their conduct, the basic intention being to protect the members from management abuses, whether in the form of improvident handling of funds or unfair conduct towards individuals."(37)

Again, an attempt to improve the basic defect of the commercial insurance in 1911 resulted in a compromise but this clearly reflected the common opinion that commercial insurance , which was based on profit, could not be beneficial to the community. The Beveridge Committee in 1941 suggested that, " a resort to monopoly was the only way of retaining the good while curing the defects and he therefore recommended the formation of an Industrial Assurance Board with a statutory monopoly of premium collection." In subsequent years, committees were appointed to suggest improvements, in view of the bad state of insurance, which resulted in profiteering, gambling and exploitation, but the fundamental recommendations of these committees entered rarely into the statute book. However, as a result of the recommendations of these committees,

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37. Clayton,op. cit., p.126

greater State intervention in different forms has been introduced in British Insurance, but the basic problem has remained unsolved till today. (38)

The insurance business, as practised in modern industrial societies, is a very civilised form of gambling or wagering, and contains all the elements of ordinary gambling. The element of uncertainty, with all its severity and intensity, is also present in insurance as it is in other forms of gambling.

The principle of indemnity is an important part of the contract of insurance and is entirely based on the risk against which insurance is required, but the risk itself is of indeterminate nature. In other words, one of the basic components of the contract of insurance i.e., indemnity, is based on the element of uncertainty. Besides, it contains the element of wagering which is reflected in the character of risk. Further, the amount of indemnity payable to any insured is not free from the element of usury or interest.

In actual practice, the principle of indemnity is often violated, especially in 'valued' and 'agreed valued' policies, and life insurance and personal insurance contracts are not contracts of indemnity, and hence, are likely to be infected with these evils to a greater degree.

The premiums are fixed arbitrarily by the insurance companies without any scientific or standard method and reflect great discrimination between various categories of insurance. The whole history of British insurance is a vivid example of how policy-holders can be defrauded and exploited in such matters. The large numbers of lapses and surrenders of policies, especially those of the lower middle class, and the ever-growing profits of the insurance companies show the scate of profiteering by the latter and of the losses by the former. Some people call insurance business an 'organised swindle' ,while others consider it another form of 'gambling ' or 'wagering' , or merely a 'speculative' enterprise.

Again, analysis of the various components of the premium indicate that it contains an element of usury and interest *(riba)*. Also the problem of the insurable interest has further complicated the problems of insurance. Inspite

of the successive Insurance Acts to rectify the defects in the insurable interest, the problem has remained as vague and complex as it was before the enactment of the statutes. Gambling and wagering has always been part and parcel of insurance and no act of pariament has ever been successful in stopping this practice.

There are many difficulties in differentiating between what is and what is not an insurable interest. These difficulties are further increased by the concept of a pecuniary interest for there are many important interests which are not capable of measurment in monetary terms.

In addition, the legality of interest at the various stages of the duration of a policy and , still further, its assignment to other persons who have no interest in it,have not , in any way helped in understanding the problem of the insurable interest. In fact, it has made the entering into of a contract of insurance, more or less, a speculative venture. That is why it is often said that 'a policy of insurance is externally hardly, if it all, distinguishable from a wager. The Assurance Acts of the eighteenth and ninteenth centuries were completely lost in the intricacies of idemnity and insurable interest and , consequently, utterly failed to solve the fundamental problem of wagering or gambling. These Acts neither prohibited nor made illegal the existing forms of gambling or wagering, but merely made them null and void; whereas all contracts, including insurance, gambling or wagering, if in conformity with the Common Law principle, had been quite legal and lawful in Britain since the Middle Ages. Common Law did not, and does not, distinguish between a policy of insurance and a wager, so long as they conform to principles, they are recognised as legal form of business and can be enforced in any Court of Law.

Above all, in all stages of its business, usury and interest *(riba)* play a leading role in the accumulation of funds of the insurance companies.

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The principle of indemnity is an important part of the contract of insurance and is entirely based on the risk against which insurance is required, but the risk itself is of indeterminate nature. In other words, one of the basic components of the contract of insurance i.e., indemnity, is based on the element of uncertainty. Besides, it contains the element of wagering which is reflected in the character of risk. Further, the amount of indemnity payable to any insured is not free from the element of usury or interest.

In actual practice, the principle of indemnity is often violated, especially in 'valued' and 'agreed valued' policies, and life insurance and personal insurance contracts are not contracts of indemnity, and hence, are likely to be infected with these evils to a greater degree.

The premiums are fixed arbitrarily by the insurance companies without any scientific or standard method and reflect great discrimination between various categories of insurance. The whole history of British insurance is a vivid example of how policy-holders can be defrauded and exploited in such matters. The large numbers of lapses and surrenders of policies, especially those of the lower middle class, and the ever-growing profits of the insurance companies show the scate of profiteering by the latter and of the losses by the former. Some people call insurance business an 'organised swindle' ,while others consider it another form of 'gambling ' or 'wagering' , or merely a 'speculative' enterprise.

Again, analysis of the various components of the premium indicate that it contains an element of usury and interest *(riba)*. Also the problem of the insurable interest has further complicated the problems of insurance. Inspite

of the successive Insurance Acts to rectify the defects in the insurable interest, the problem has remained as vague and complex as it was before the enactment of the statutes. Gambling and wagering has always been part and parcel of insurance and no act of pariament has ever been successful in stopping this practice.

There are many difficulties in differentiating between what is and what is not an insurable interest. These difficulties are further increased by the concept of a pecuniary interest for there are many important interests which are not capable of measurment in monetary terms.

In addition, the legality of interest at the various stages of the duration of a policy and , still further, its assignment to other persons who have no interest in it,have not , in any way helped in understanding the problem of the insurable interest. In fact, it has made the entering into of a contract of insurance, more or less, a speculative venture. That is why it is often said that 'a policy of insurance is externally hardly, if it all, distinguishable from a wager. The Assurance Acts of the eighteenth and ninteenth centuries were completely lost in the intricacies of idemnity and insurable interest and , consequently, utterly failed to solve the fundamental problem of wagering or gambling. These Acts neither prohibited nor made illegal the existing forms of gambling or wagering, but merely made them null and void; whereas all contracts, including insurance, gambling or wagering, if in conformity with the Common Law principle, had been quite legal and lawful in Britain since the Middle Ages. Common Law did not, and does not, distinguish between a policy of insurance and a wager, so long as they conform to principles, they are recognised as legal form of business and can be enforced in any Court of Law.

Above all, in all stages of its business, usury and interest *(riba)* play a leading role in the accumulation of funds of the insurance companies.

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38. Clayton,op. cit., p. 181.

7

INTEREST *(RIBA)*

In order to judge the legality or illegality of commercial insurance we have to analyse the nature of certain elements which are forbidden in Islam. If any of these elements are found in commercial insurance, it will render the insurance contract illegal and invalid. Therefore, it is quite logical to analyse these elements before we can pass any judgement on commercial insurance. (1)

1. INTEREST *(Riba)*

The first of the elements forbidden in Islam is interest i.e. *riba*. Islam regards interest as an economic evil harmful to society, economically, socially as well as morally. Therefore the Holy ***Qur'an*** forbids Muslims to give or take interest. But as this evil was deeply rooted in the economic and social life of the community, the law of prohibition was gradually introduced to avoid unnecessary inconvenience and hardship to the people. (2)

(a) The first injunction of the ***Holy Qur'an*** only reminds people that interest does not add anything to individual or national wealth but, on the other hand, decreases it ***(Qur'an: 30:39).***

"That which you give in interest in order that may increase on other people's wealth, it increases not with ***Allah;*** but that which you give in charity, seeking ***Allah's*** pleasure, increases manifold."

(b) The second Commandment forbids Muslims to take compound interest (usury) if they want real and lasting happiness, peace of mind and success in life ***(Qur'an: 3:129):***

"O you who believe; Devour not usury, doubling and quadrupling, the sum lent. Fear ***Allah*** and observe your duty to Him, that you may really prosper."

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1. See details in volume 111 chapter 4 of this book
2. Syed Abul Ala Maududi, ***The Meaning of the Qur'an,*** Vol: 11 p. 62 Footnote, 99.

*"The devouring of interest had created greed, avarice, parsimony and selfishness in those who took interest; hatred, anger, enmity and jealousy in those who had to pay it. Therefore, **Allah** had condemned and prohibited interest and prescribed charity as an antidote to it."* (2)

(c) As some people were mixing trade with interest and did not find much difference between the two, the Holy ***Qur'an*** warns them of the evil consequences of this attitude and admonishes them to abstain from this evil practice in these words ***(Qur'an: 2: 275-276)***

"But those who devour interest cannot stand except like the one whom Satan has bewitched and maddened by his touch. They have been condemned to this condition because they say, "Trade is just like interest," whereas ***Allah*** has permitted trade and forbidden interest. He who after receiving admonition from his Lord, abstains from taking interst, shall be pardoned for his action; his affair is with ***Allah*** (to judge). But he who repeats the same offence, he shall go to Hell, where he shall abide for ever. ***Allah*** has deprived interest of all blessing and made charity fruitful. And ***Allah*** likes not an ungrateful sinful person."

In this verse "the money-lender is likened to a madman. Just as a madman loses his sense on account of his disordered intellect, in the same way the money-lender is so concerned with money-making that he divorces himself from common sense. He is so senselessly foolish and impudent that he does not mind how his selfishness and greed are cutting at the very root of human love, human brotherhood and fellow feeling, and destroying the common good of mankind. He does not care that he is gaining prosperity at the expense of many. This is how he behaves like a madman in this world. In the next world he will rise like a madman at the time of Resurrection,for, in the Hereafter a person will rise in the same condition in which he dies here." (3)

Besides, this verse clarifies the fundamental difference between profit and interest as summarised below:–

(i) "The settlement of profit between the buyer and the seller is made on equal terms. The buyer purchases the article he needs and the seller gets profit for the time, labour and brains he employs in providing that article to the

buyers. In contract to this, in the case of interest, obviously the debtor cannot settle the transaction on equal terms with the creditor because of his weaker position. As far as the money lender is concerned, he gets that fixed sum of interest which he considers as his profit. If the debtor spends the borrowed money in fulfilling his personal needs, the time factor definitely does not bring any profit at all. And if he invests that money in trade, commerce, industry, agriculture, etc., then there are equal chances of profit or loss. Thus lending money at interest might bring a guaranteed and fixed profit to one party and loss to the other, or a guaranteed and fixed profit to one party and an uncertain and indefinite profit to the other.

(ii) The trader charges his profit; however high it may be, once and for all, but money-lender goes on charging interest over and over again and goes on increasing with the passage of time. The profit which the debtor makes on money of the creditors, however, large it may, has after all its own limits, but there is no limit to the interest the creditor may charge on his money. He may, as sometimes actually happens, receive all the earnings of the debtor, may even deprives him of all the means of livelihood or of the articles of his personal use and still might have the same amount of debt against him that was at the time of borrowing.

(iii) The transaction in trade comes to an end as soon as the article and its price change hands. After this the buyer is not required to return anything to the seller. As regards the rent of furniture, house, land, etc., the lent thing is not itself spent up but is returned to the owner after the term. But in the case of the principal the debtor has to spend it first and then reproduce it and return it, to the creditor along with the interest. Thus the debtor runs a double risk; he has to reproduce the principal and also to produce its interest.

(iv) One engaged in trade, industry, agriculture, etc., earns profit by spending time, labour and intelligence, but the money-lender becomes the stronger in the earnings of the debtor without any risk or labour on his part simply because he invests the money which is over and above his needs. He is a partner only to the extent that he is entitled to a fixed guaranteed interest, irrespective of whether there is any profit at all or how much, or whether there is even a loss.

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3. The Meaning of the Qur'an, Vol. 1, op.cit., 198. Footnote, 316.
4. The Meaning of the Qur'an, op. cit., p. 199. Footnote, 318.

From the above it becomes quite clear that even from the economic point of view, trade helps construct society but interest leads to its ruin. As for the moral point of view, interest, by its very nature, creates parsimony, selfishness, cruelty, hard-heartedness, money-worship, etc., and kills the spirit of followship and co-operation. It is, therefore, ruinous for society both morally and economically." (4)

Charity on the other hand, leads to economic prosperity. " If the well-to-do people of society spend money liberally in buying their necessities of life and those of their dependents, and distribute a part of their wealth among the needy to enable them to buy their necessities of life, or if they lend it to businessman without interest, or invest it in a business on the basis of partnership, or lend it without interest to their Government for national services, then obviously, commerce, industry, agriculture, etc., will thrive and reach a very high standard. The standard of national prosperity will rise higher and higher and the production of its wealth will become larger as compared with the country where interest is lawful. Thus it is clear that interest hinders the progress of a nation and charity helps its development." (5)

(d) Then came the final Commandment of ***Allah***, prohibiting interest and declaring it unlawful in our Islamic society (2:278). "O Believers, fear ***Allah*** and give up what is still due to you from interest, if you are true believers; but if you do not do so, then take notice of war from Allah and His Messenger. If, however, you repent and forego interest you are entitled to your capital, do no wrong, and no wrong will be done you. If your debtor be in straitened circumstances give him time till his monetary condition becomes better. But if you remit the debt by way of charity, it will be better for you, if you only knew it."

(e) The Muslims are also warned to abstain from interest and obey the Commandment of ***Allah***, or else they shall suffer the fate of the Jews, who were forbidden to take interest, but they continued to do so (4:161); " Because they take interest, which had been prohibited, and because they devour unlawfully the property of others. And We have prepared a painful torment for the disbelievers."

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5. *The Meaning of the Qur'an,* Vol.1. op. cit., pp.201–205, Footnote 320.

The Holy Messenger of Allah, on his last Pilgrimage and in his last address declared the prohibition of interest in these words: " Every form of (false) interest is cancelled; capital indeed is yours which you shall have; wrong not and you shall not be wronged. Allah has given His Commandment to this prohibiting *(riba)* interest. I first start with the amount of interest which people owe to Abbas and declare it all cancelled." He then on behalf of his uncle, Abbas, cancelled the total amount of interest due to his loan capital from his debtors." (6)

The above verses of the *Qur'an* and the clarification of these by the Holy Messenger explicitly (without any shadow of doubt) prohibit *(riba)* interest and declare it unlawful in a Muslim society.

" The Arabic word ' ***riba*** ' literally means " increase in " or " addition to " anything. Technically it was applied to that creditor charged from the debtor at a fixed rate on the principal he lent, that is, interest. At the time of the revelation of the *Qur'an* , interest was charged in several ways. For instance, a person sold something and fixed a time limit for the payment of its price, and if the buyer failed to pay it within the fixed period, he was allowed more time but had to pay an additional sum. Or a person lent a sum of money and asked the debtor to pay it back together with an agreed aditional sum of money within a fixed period. Or a rate of interest was fixed for a specific period and if the principal along with the interest was not paid within that period, the rate of interest was enhanced for the extended period, and so on." (7)

After studying various forms of business and credit transactions, containing the element of ' ***riba*** ' which were in vogue in Arabia during the time of the Holy Messenger, ' ***riba*** ' may be defined as a predetermined excess or surplus over and above the loan capital received by the creditor conditionally in relation to a specified period. It contains the following three elements.

1. Excess or surplus over and above the loan capital (i.e., the principal).

2. Determination of this surplus in relation to time.

6. Imam Malik, *Mautta.*
7. *The Meaning of the Qur'an,* op. cit., p.189. Footnote 315.

3. Bargain to be conditional on the payment of a predetermined surplus to the creditor.

The presence of these elements jointly constitute ' ***riba*** ' and any deal, bargain, or credit transaction, in money or in kind which contains these elements, is considered a transaction of ' ***riba*** ' (or interest) by the Muslim jurists and economists, and is unlawful in Muslim society. (7)

As far as commercial insurance is concerned, it is dependent for its profits on interest which is completely involved in it at all stages of its business, from the calculation of the premiums to the payment of indemnity to the insuree who has suffered a calamity. Most of the funds collected in premiums are invested in fixed-earning (i.e., interest) investments by the insurance companies and only a small portion of their monies is invested in other projects. This is because they consider it safe and free from risk, and as their policy is to play safe in order to protect the interests of their clients, fixed-earning investments are the most likely choice for them.

" The financial aspects of life assurance arise from the fundamental principle of scientific life assurance under which a level premium is charged for an increasing risk. This leads to an accumulating fund, in which the income enters and outgoings leave the funds in the form of cash, but the fund does not remain unproductively in this form. While life assurance is perfectly feasible at a zero rate of interest, it could be more costly. Most of the fund is therefore invested to produce interest. The financial factors which exert an influence on the fund are, therefore, the rate of interest, the rate of tax, the value of the assets, currency, and, of course, the operation of the fund means outgoing for expenses." (9)

In fact, the story of commercial insurance in the Western World is a story of interest and the two are so closely linked that it would be difficult, if not impossible, to separate them within the existing system.

But some ' people ' argue that Islam does not forbid interest ***(riba)*** in insurance

8. For details see vol 111 of this book.
9. Fisher H.F. and Young J. ***Acturial Practice of Life Assurance,*** London, 1971,p.148–9.

because this organisation has to be maintained, various obligations to be met and workers to be paid from the excess earnings. Therefore, they seem to feel nothing wrong with interest in insurance. They emphasise that what Islam has disallowed are certain sales and contracts on account of the unlawful terms and conditions. As such one should see interest in the same perspective and distinguish between insurance function and insurance policies that are contracts. If the insurance companies play safe with their monies by investing them in fixed earning(i.e. interest) investments and not investing elsewhere in other more risky enterprises, they are merely trying to safeguard the money of their policy-holders. This is like a Muslim trader who does his business strictly according to the law of ***Shariah*** but now and then lends money on interest. One cannot condemn him outright as the two issues are entirely separate.

One fails to understand the purpose of their line of argument and how it can make lawful what ***Allah*** has forbidden in very clear words in the *Holy Qur'an*. Even if there is some difference of opinion among the jurists with regard to the validity or invalidity of a certain sale or business contract, there is complete unanimity on the prohibition of interest in very absolute terms. How can the action of a Muslim Trader be justified who now and then lends money on interest? Whenever one commits a crime and is caught, one is punished. If you condemn such actions, you open the door for lawfulness in society. The law is law and must be respected under all circumstances.

Whenever an individual or an institution takes interest, no matter in what form and for what purpose, it is an unlawful and invalid action in the eyes of *Shariah* and no amount of jugglary with words or concepts can fustify it or legalise it. In short, interest is strictly forbidden by *Shariah* and business of modern commercial insurance in practice thrives on interest.

8

GAMBLING *(MAISIR* Or *QIMAR)*

The second element forbidden by ***the Qur'an*** is gambling. This evil was also gradually eliminated from society. The first Commandment simply referred to its evils and pointed out that its evil was greater than its profit. " They ask you concerning wine and gambling. Say, " In them is great sin and some profit for men; but the sin is greater than the profit" (2:219).

This was the first introduction regarding gambling with disapproval as a social evil. The next and final step was to prohibit this practice altogether. " O Believers! wine and gambling – and divining arrows are an abomination of Satan's handiwork. Leave it aside in order that you may prosper. Indeed Satan intends to sow enmity and hatred among you by means of wine and gambling, and to prevent you from the remembrance of ***Allah*** and from prayer. Will you not, therefore, abstain from these things? Obey ***Allah*** and His Messenger and abstain from these things" (5:90).

All forms of gambling and betting are prohibited and are considered acts of impiety and abomination. " It is also unlawful for you to try to find fortune by means of divining devices, for all these things are sinful acts" (5:3).

These Commandments finally made gambling or betting in all its forms absolutely unlawful for the Muslims.

The Arabic word used is ' ***maisir*** ' which literally means getting something too easily wihout hard labour, or receiving a profit without working for it; therefore it is called gambling. " That is the principle on which gambling is prohibited ... Whether you got a big share or a small share, or nothing, depended on pure luck (i.e., chance) unless there was fraud also on the part of

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some persons concerned. The principle on which the objection is based is: that even if there is no fraud, you gain what you have not earned, or lose on a mere chance. Dice and wagering are rightly held to fall wihin the definition of gambling." (1)

The Arabic word *'azlam'* used in the *Qur'an* also refers to the practice of gambling. *'Maisir'* on the other hand, applies to all these forms by which wealth is acquired or divided by devices of chance, for example, lottery, betting, wagering or gambling., etc.

Thus gambling in general *(maisir)* and raffling in a particular way *(azlam)* and all other forms of betting, raffling or lottery which, on principle, come under gambling are prohibited in Islam. The Holy Messenger prohibited all forms of business in which the monetary gain comes from mere chance, speculation and conjecture (i.e., gambling) and not from work.

Habal-al-Habla

" it is narrated by Abdullah bin Omar that the Holy Messenger forbade the sale called ' *Habal-al-Habala* ' which was a kind of sale practised in the pre-Islamic days of ignorance period. In this sale one would pay the price of a she-camel which was not born yet but would be borne by the immediate offspring of an expectant she-camel." (2)

(b) Muzabanah and *Muhaqalah*

These two forms of business transaction were very common in the pre-Islamic period. *Muzabanah* was the exchange of fresh fruit for dry ones in a way that

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1. *Holy Quran,* A.Yusuf Ali, p.86.
2. *Bukhari* English translation by Dr. Mohammad Muksin Khan.vol.111.p. and *Muslim* translated by Mr. Abdul Hamid Siddiqui vol.111,p.798.no.3615-3616
3. *Bukhari,* Vol.III, op. cit.

the quantity of dry fruit was actually measured and fixed, but the quantity of fresh fruit given in exchange was guessed while still on the trees. Likewise *muhaqalah* was the sale of wheat in exchange for wheat in ear which was estimated by conjecture while still in ears. (3)

It is reported by many companions of the Holy Prophet, including Jabir, Abu Hurairah, Abu Saeed Khudri, Saeed bin Al-Musayyib and Rafey bin Khadij that God's Messenger forbade the transactions of *muzabanah* and *muhaqalah.(4–7)*

(c) Sale of Fruits before Ripening *(Mukhabrah)*

Zaid bin Thabit said that in the life time of Allah's Messenger people used to trade with fruit and many complaints arose. Allah's Messenger told them not to sell the fruit before their benefit was evident (i.e. they were free from all dangers of being spoiled or blighted)". (8)

It is reported by Abdullah bin Umar, Jabir and Zaid bin Thabit that God's Messenger forbade the sale of fruits till they were clearly in good condition. He forbade both the seller and the buyer to enter into such a transaction."(8)

It is narrated by Anas bin Malik that God's Messenger forbade the sale of fruit till they were almost ripe. He was asked what was meant by 'are almost ripe', He replied, "Till they become red." Allah's Messenger furthermore said," If Allah spoiled the fruits , what right would one have to take the money of one's brother (i.e. other people)."(9)

In fact *mukhabarah* refers to the sale of grain or vegetables before it is ripe. It was forbidden by the Holy Prophet in order to protect the interests of the

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4. *Mishkat al Misabih,* English translation by James Robinson, Vol.II p.607 and *Muslim* Vol. III op. cit., p.809 No. 3707 and *Abu Daud* Urdu Translation by Wahiduz Zaman Vol.III p.33–34
5. *Ibn Majah* urdu translation by Wahiduz Zaman Khan, Vol.II p. 180
6. *Tirmizi* urdu translation by H. Hamidur Rahman Siddiqui, Vol. I p.566
7. *Bukhari,* Vol. III op. cit., p.215
8. *Bukhari, Vol. III* op. cit., p.218–20
9. *Bukhari,* op.cit., p.221–224

buyer during the period of purchase before ripening when many kinds diseases, storms, could destroy the fruit or corn crops and ruin the buyer.

A study of the above mentioned sayings of the Holy Prophet show that forbade all sales and transactions which were based on guess, conjecture speculation and therefore contained an element of chance or gambling.

(d) Sale of goods before obtaining their possession

The Holy Prophet had forbidden the sale of foodstuffs or goods before tak them into one's possession. " Ibn Abbas reported that Allah's Messen forbade the selling of foodstuffs before measuring and transferring them one's possession. According to Ibn Abbas, what applies to cereals also appl to other categories of goods. On another occasion the Holy Prophe said, "Bargain not about things which are not with you (i.e. are not in yo possession). (10)

It is reported by Ibn Umar, Jabir and Abu Hurairah that God's Messenger said "He who buys foodstuffs should not sell it till he has received it." (10-12).

This in the opinion of the four Imams shows that it is not right for the seller to sell foodgrain before taking possession of it. And according to Imam Shafei it is not right to sell anything, foodgrains, land or garden before taking possession of it; Imam Ahmad is of the opinion that possession is not essential in the case of land, garden and houses. The sale of commodities, especially perishable ones, not in the possession of the seller, was prohibited by the Holy Prophet because of the element of doubt in their delivery to the buyer. There was no

10. ***Bukhari,*** Vol. III, op. cit., p.193–4 and ***Ibn Majah,*** Vol. II (No 1595) op. cit.,p.165 and ***Abu Daud,*** Vol. III op. cit.,p.60–2
11. ***Muslim,*** Vol. III, op. cit, p.803, ***Ibn Majah,*** Vol. II, op. cit. p.165 and ***Abu Daud,*** Vol.III, op. cit., p.60–2
12. ***Tirmizi*** Urdu, Vol.I, op. cit., p.569 and ***Abu Daud,*** Vol. III, op. cit., p.64 and ***Muslim,*** Vol. III, op. cit., 805 and ***Ibn Majah,*** Vol.II, op. cit.,p.165

equal chance that the delivery could not be accomplished by the seller due to many unforeseeable circumstances. It is more or less like a gamble, the thing may or may not be delivered. There is definitely some element of doubt and chance. Besides, it would be unfair to the buyer if the thing was lost or destroyed before it was delivered to him."(13)

(e) ***Al-Limas*** **or** ***Mulamasah***

Al-Limas *is* a sale in which the deal is completed if the buyer touches a thing, without seeing or checking it properly. The sale becomes valid on buyer's touching the clothes without checking or looking at them. For example, a person brings a folded garment or wrapped cloth possibly in the dark and the buyer offers a price and the seller of the object says," I sell it to you on the condition that you will only touch it but not see it, and if you see it, you have no right to cancel the sale." Anas, Abu Saeed and Abu Hurairah said that the Holy Prophet forbade it (i.e. ***Al-Mulamasah sale***).(14)

(f) ***Nibadh*** **or** ***Munabazah***

Nibadh is a sale in which the deal is completed when the seller throws a thing towards the buyer giving him no opportunity to see, touch or check it. The very act of throwing the thing will mean that the bargain has been struck. It is narrated by Abu Hurairah, Anas and Abu Saeed that the Holy Prophet forbade sale of ***An-Nibadh*** (or ***Munabazah).***" (18)

Both these forms of sale are like gambling. Two persons may agree to exchange one thing for another without seeing or checking either of them.The whole transaction in both forms of sale is based on sheer chance or conjecture. Therefore both these forms of business transactions were prohibited by the

13. ***Hedaya,*** p.275–79
14. ***Bukhari,*** Vol.III, op. cit., p.199–201, ***Muslim,*** Vol. III, op. cit., ***Abu Daud,*** Vol. II, op. cit., p.633 and ***Mautta Imam Malik,*** urdu translation by uz Zaman, p.352
15. ***Muslim,*** Vol. III, op. cit., p.810, ***Ibn Majah, Vol.*** II, op. cit., p.163 and ***Tirmizi,*** Vol. I, op. cit., p.601

Holy Messenger . In both cases the buyer has got no opportunity to examine or check the things sold to him and the transaction is complete. It is a leap in the dark (i.e. a gamble).

(g) *Muawamah* **(Forward Selling)**

Muawamah refers to the selling of fruit from the trees or corn in the ears for a period of one, two or even three years before the crop has grown. This practice of selling the harvest for a number of years before the crop is grown is more or less like gambling. It is like ***Muzanabah,*** The bargain is not based on reality but chance or conjecture, and is therefore prohibited by the Holy Prophet. Jabir reported Allah's Messenger forbidding the selling of (produce) in advance for two years or the selling of fruit (on the trees) in advance for two years.(15)

Thus all bargains that are clinched without giving the buyer a fair reasonable opportunity of examining the things and the result of which is more or less dependent upon chance and conjecture and not on reality are forbidden in Islam.In other words, all forms of business transactions which are in the nature of gambling or lottery are declared unlawful.

To sum up, all bargains and transactions which are in the nature of gambling, wagering or betting are forbidden in Islam. There is a clear text in the *Qur'an* which completely prohibits all dealings of this kind. The Holy Prophet prohibited gambling in all its forms where elements of betting, raffling, conjecture, speculation, chance, etc. were present. Any business transaction which contains any of these elements is null and void.

Finally to summarise it may be said that all forms of business dealings which contain the elements enumerated above belong to the same kind as gambling and are, therefore, illegal in a Muslim society according to the clear text of the ***Qur'an*** and ***Sunnah*** of the Holy Prophet. There is a clear direction to abstain from gambling in all its forms and to obey the Messenger of Allah to secure their influence and prosperity. If they disobey they are warned of the evil consequences of their action and are told that Allah'a Messenger'duty was only to convey the Message in clear and plain language.

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15. ***Muslim***

It is necessary to see if there is any element of the species of gambling in commercial insurance as practised in modern industrial society. If such an element is shown to exist in the modern commercial insurance it will be unlawful, but otherwise it will be lawful for Muslims.

A cursory study of commercial insurance business will show that it does resemble gambling and the insurance companies are like the 'bank in betting' and receive premiums from the insured and pay out in case of loss, risk or death to the sufferer. And a number of economists have admitted that commercial insurance 'is a form of gambling or speculation and therefore could not be considered within the ambit of co-operative activities.'(16)

A study of the history of British Insurance shows that commercial insurance is in no way very different from gambling. This fact underlines the distinction insurers have always been anxious to draw between insurance and gambling. In the early days of insurance, policies were taken out which were no better than wager, as the proposers had no personal cover. With the passing of the Marine Insurance Act of 1745, the necessity for an insurable interest was established in relation to ships or cargo. Wagers were still made on the lives of illustrious persons until a public scandal ended by the the Insurance Act of 1774.(17)

The fact remains that the wagering element has remained an integral part of insurance in Britain (and other countries are no exception) in spite of successive Acts of parliament since the middle of the eighteenth century. Every new Act has further added to the problem of insurance as explained earlier under the general conclusions in the chapter on 'Analysis of the Modern Insurance Contract'.The problem has remained as evasive as it was before in earlier centuries and we are now no nearer to its solution.

If we compare commercial insurance with gambling we find a close resemblance between the two:

(a) There is a great similiarity between the contract of commercial insurance and that of gambling.

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16. Barou N., ***Co-Operative Insurance,*** London, 1936, p.43
17. Cathpole W.L., ***Business Guide to Insurance,*** London, 1974,p.14–15

(b) In both, the amount betted (or insured) is paid back to the better (
insured) when certain events have taken place.
(c) In the case of the non-occurrence of an event, nothing is paid back to
better (or insured). This applies both to commercial insurance and betting.
(d) How the bet or stake in case of betting (and peril in case of commerc
insurance) will actually occur and who will be the winner, the better in case
betting (and the insuree in case of commercial insurance) or the house (or
insurance company) is anybody's guess.
(e) The premium money in commercial insurance is exactly like the stake
betting as far as legal commitments are concerned.
(f) The gain of the house in betting and the company in insurance is alwa
certain, while the gain of the better or the insuree is doubtful; he may gain
lose.
(g) On the whole, the house against all gamblers, and the commercial insura
company against all the insured, are always the winners.

Thus the element of gambling and wagering is obvious in the contract
insurance.

In order to specify and locate the various elements of gambling in commerci
insurance, it would be appropriate to study and analyse the basis of commerc
insurance business i.e. the contract of insurance , which contains its m
objectives.

A contract of insurance can be defined " as a contract for the payment of a su
of money, for some corresponding benefit, to become due on the happening
an uncertain event of a character adverse to the interest of the person effecti
the insurance." The contract of insurance has the following main features:
(a) The payment of a sum of money by the insuree to the insurance company.
(b) The payment of an unspecified benefit to the insured by the company.
(c) The event itself is of an unsertain nature, the happening of which is
unknown quantity.
(d) The insurable interest of the insurance.
(e) Obviously, there is element of risk involved in this contract, affecting mainly
the interests of the insuree.

Now we will discuss these features.

(a) Premiums

The premium is the price paid by the insuree in exchange for some corresponding benefit by the insurer to the former on the happening of an event and one which the latter is prepared to take the risk of repairing the loss of the former. The net amount of premium is determined by the same formula as in gambling. It represents approximately commission, expenses, profits and the actual value of the occurrence or peril. Apart from expenses, other elements, especially risk money which is the chief determining factor, are known quantities. The actual amount of premium money to be paid by the insuree will be determined by approximation and conjecture, representing other things, the full insured value of the probable peril.

Thus the basis on which premium money is determined is for all practical purposes the same as that of a stake in gambling or betting. The nature of premium money is almost the same as the stake money in gambling. " As future rates of mortality, interest and expenses cannot be accurately forecast, it is not possible to fix a premium which, on the average, will exactly cover the risk and a margin has to be allowed."(18) The insuree might die (or suffer a peril) after paying his very first premium, yet the insurance company will pay him the full amount of insured money (or indemnity) agreed upon at the time of insurance contract. This could be a huge amount against a small and insignificant sum of money paid in the first premium instalment.

Again, the insuree may pay his premium instalments for years without the event happening and may get nothing in exchange for all the premium money. If this is not gambling, then what is gambling? Furthermore, the insuree does not know how much and for how long he must pay – the probable event may never happen.

(b) Indemnity

An indemnity is the sum of money the insurance company is expected to pay to the insuree in the case of an accident or danger. It is also a leap in the dark. Even if all the amounts are statistically calculated the element of probability

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18. Holder, op. cit., p.25

(i.e.gambling) cannot be eliminated from commercial insurance.In gambling calculations are based on similar statistics in order to ensure profits for the house (or bank), but it does not change the nature of gambling.

"Closely linked with the insurable interest is the principle of indemnity which means restoring the policy-holder after the insured event to his position immediately before it. The measure of indemnity is in money terms though the objective may in some cases be reached by repair or reinstatement instead of a cash payment. Settlement is limited to the sum insured, and if the policy-holder is under-insured, he may not receive full indemnity. The same applies if he has infringed policy condition. The essential feature of the indemnity is that the policy-holder should not be better off as a result of the insured event happening. Ideally, he receives in cash or otherwise the exact measure of his loss and even if he is insured for more than is necessary he is not entitled to recover more than the cost of making good that loss."(19)

The insurance companies make use of their past experience and past statistics against the unknown risks and make great overall profits. If nothing happens, they keep all the premium money and make huge profits. If, on the other hand, too many accidents occur, which rarely happens, they may suffer losses during that particular period, but their gains in the earlier years can easily offset their losses and, on the whole, they make profits.

Past experience has shown that insurance companies, like the house in gambling, never lose. They are always the winners and the insurees, like the betters, are always the losers.

Above all, the insurance company can never know exactly how much and when it has to pay because the occurrence of a peril is an unknown quantity and cannot be known. The peril will always remain an uncertain event and so will be commmercial insurance. Insurance companies can never accurately estimate the number of claims and the amount involved during any particular period. Thus insurance business is primarily based on the risk element which is of an uncertain nature and, therefore, dependent on pure chance.

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19. Holder, op. cit., p.25–30

(c) Risk Element

The insurance company promises to repair the damage of the insuree on the happening of an uncertain event. Thus it seeks profits by providing cover against danger or peril to the insuree or his property. In other words, it guarantees some benefit against probable danger to the insured or his property in return for the payment of a premium by the latter. The risk element involved in this contract of insurance is of very uncertain nature, it may happen or may not. The nature of this risk is uncertain like the risk in gambling or betting. Insurance and gambling are on the same footing as far as risk element or danger is concerned.

The parties in an insurance contract do not know exactly what their obligations and responsibilities are to each other and are not sure how to work for their objectives. The peril may never occur, and if it occurs, how much damage will be covered and what sums of money will have to be paid by the insurer, are all unkown quantities. It is doubtful if these quantities will ever be known to the parties concerned before the happening of an event.

As the nature of the event is uncertain, the insured will never know how many premium, and how much money he is going to pay before the occurrence of a peril.Thus the whole matter is based on mere chance as in gambling or betting.

(d) The Insurable Interest

The absence of the necessity for an 'insurable interest' before the Act of 1774 led to gambling and wagering in the insurance business. In order to stop wagering 'insurable interest' was precisely defined in the Insurance Act of 1774. "It was found,however, that insurance on lives or other events in which the assured had no interest, involved undesirable gambling, and by Life Assurance Act 1774, commonly called the Gaming Act, it was provided":

1. That no life insurance should be made unless the person effecting the assurance had an interest in the life assured, and that any life insurance made without such interest should be null and void.
2. That no greater sum should be recovered than the amount or value of the interest of the assured.

Most life assurance are made by persons on their own lives where insurable interest is higher than a pecuniary interest and is not capable of evaluation. Apart, however, from cases of insurances made by persons on their own lives, or life of a husband or wife, the insurable interest must be a pecuniary interest capable of valuation in money, and must be founded on the obligation, or liability which will, or will be likely to, result from the death, or the loss or diminution of any right to property which would be recognised at law or in equity. A moral obligation or an expectation, however, is not sufficient.

3. Section 3 of the Life Assurance Act 1774,,provides that no greater sum shall be recovered from the insurer or insurers than the amount or value of the interest of the asssured. The sum assured at the outset must be supported by an insurable interest of equivalent amount." (20)

The Act defined the insurable interest but failed to show how an insurable interest in a human being, as on the life of a husband by a wife could be measured or calculated in monetary terms. Thus 'insurable interest' has remained an enigma for insurers as well as insurees because it is not possible to measure accurately the interest of the insured.(21)

Hence, the successive legislative measures of the British parliament have failed to stop wagering in insurance. The story of insurance in other countries of the West is no different or better than that in Britain – the wagering element is rampant throughout the business of insurance.

Arguments in support of Insurance

The supporters of commercial insurance have argued that the latter is valid and lawful like any other business and there is nothing wrong in it. Their arguments are summarised below:

1. The insurance contract is reciprocal in the sense that the insurer will not pay the indemnity if the insuree does not keep his part of the contract, i.e. pay the premium instalment.

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20. Holder, op. cit., p.26–7

21.For details see chapter on "Analysis of the Modern Insurance Contract'

Reciprocity is only valid as far as the legal aspect of the contract of insurance is concerned, in practice it does not exist as has already been pointed out. It is the insured who always loses and suffers, whereas the insurance company's loss is uncertain and partial. In the end the insurance company, the house in gambling, always wins. The insuree has always got to pay premium monies to get his loss repaired but in the case of the non-occurrence of a peril he gets nothing. Where is the reciprocity in this case?

2. It is argued that an insurnace contract is not an indefinite contract but is always a dated one, and has clearly specified the date of commencement and payment on the occurrence of a peril. In addition, it is often well publicised and terms are defined and printed and form part of the contract.

In practical terms each insurance contract is an indefinite contract because it is renewed every year, otherwise it is of no consequence if it is terminated at the end of the first contract term. Even if it is not an indefinite contract, it will not substantially change the nature of the risk element involved in it. The risk element, which is the main determinant of the nature of the insurance contract, whether it is wagering or not, remains the same irrespective of the terms of the insurance contract.

Likewise, defined, publicised or printed terms of the contract will not change the nature of the risk element, and the fundamental problem of wagering in insurance remains unaltered.

3. Commercial insurance is like an ordinary business, in which risk is essential and indispensable for profitmaking in the modern industrial world. Both the parties in the insurance contract are taking a risk voluntarily and knowingly. They are in a sense co-operating to avoid danger and restore equality or balance, through risk. Therefore, risk-taking in commercial insurance is based on different grounds from gambling.

This line of argument is absolutely fallacious and misleading. The risk involved in a normal business contract is almost negligible and is of a quite different substance and nature from that found in commercial insurance. The latter

cannot be compared to the normal business risk, if any. There is practically no such risk in business in normal conditions, except in speculative enterprises which are, anyway, unlawful in a Muslim society.

Besides, as has been pointed out earlier, in commercial insurance the risk is usually one-sided, it is the insuree who always bears the risk and the company on average makes a profit like the house in gambling. Hence there is no justification for saying that an insurance risk is based on different grounds from those in gambling. The fact that the parties take risks voluntarily and knowingly does not alter the fact that the venture is in the nature of gambling. As for the claims with regard to inequality in the economic sense and the role of insurance in co-operation with the insurees to restore equality or balance through risk, facts belie the statements of the supporters of commercial insurance.There is no co-operation on the part of the insurees, jointly or severally, with the insurance company. It is an assumption on their part and exists neither in the insurance contract, nor was it the intention of the directors of the company or of the individual insurees at the time of the insurance contract.

Furthermore, this desire to avoid danger and restore equality or balance is merely the invention of the supporters for no such desire exists in the insurance contract.

4.Commercial insurance is not based on risk alone for there are terms and conditions attached to the insurance contract. In gambling one is willing to hand over money out of greed with the possibility of getting more money, or nothing; whereas in insurance one does not wish to waste one's money but is trying to safeguard one's interests against future peril. In gambling one may either lose all or earn huge amounts, but in insurance this is not the case. One is insured against certain kinds of perils and the question of loss does not arise.

The first part of the argument has already been discussed in point number 3. It is not true that a gambler is wasting his money with full knowledge of his loss. If he were sure that he would lose under all circumstances he would never stake his money. He ventures his stakes in gambling with the hope that he will make more money out of it. The result is uncertain; the stake may bring more money or may bring nothing– it all depends on chance.

Likewise,the insuree is trying to safeguard his interest against a future hazard, which is of uncertain nature. Both the insuree and the gambler are faced with a situation of the same nature. The insured may, like the gambler, lose all his premium money and get nothing if the event against which he has insured does not occur. Thus this gain or loss is entirely dependent upon the happening of an event which is uncertain. Chance plays an important part both in commercial insurance and gambling.

5. Commercial insurance is not like gambling because the insuree is paid his actual losses incurred from a peril and from his own savings paid earlier by premium instalments. In fact the insuree put up their money together in the form of premiums to pay off the claimants who have suffered a calamity.

It is fallacy to call premium money paid by the insurees to the insurance company as their savings. The insurees as individuals had no such intention at the time of the insurance contract, and there is nothing in the insurance contract to suggest that the insurees pay premium money to pay off the losses of those who have suffered a calamity. In fact, each individual insuree pays premium money to the insurance company to secure his own interests against future losses.

6. The insurance company helps other people in peril and reduces their misery by making up their losses. Many calamaties and hazards are compensated, removing the miseries and suffering of hundreds of families. There is co-operation between the two parties to achieve the above objectives.

We have already dealt with the problem of co-operation and the rest of the argument does not alter the fact that commercial insurance contains an element of gambling. If people are prepared to pay the legal expenses of a thief, that would not justify theft on the basis of co-operation by the people, or make it lawful for the people to share the booty between them to ward off their poverty.

The insurance company tries to spread the risk by insuring their risks with bigger companies (i.e., by re-insuring) and the insurance company is only a

form of organisation or management which receives premium money and pays out in case of the loss, risk or death. It is no more than a co-operation.

But re-insuring by a insurance company with a bigger company (i.e., a company's syndicate) to spread its risk does not alter the position explained above. On the other hand, it further complicates it because the companies make profit out of interest in addition to their gambling ventures.

In fact, the insurance companies enter into contract with each insuree separately and their contracts are limited to one individual insuree which is pure gambling. The mere multiplicity of such contracts with thousands of insurees does not change the nature of each individual contract. The nature and terms of an insurance contract of each individual insuree remains unaltered in spite of a change in the number of insurance contracts, which is a matter for the insurance company not for the individual insuree.

What the insurance company pays in compensation and what it takes as premium money from each individual insuree are not dependent upon the relationship between the insurance company and the mass of insurees as are alleged by the supporters of commercial insurance. The source and the basis of insurance is the insurance contract which does not mention this co-operative relationship.

8. The insuree is paid his actual losses from a peril out of his own contribution to the company in the form of premium. Therefore, the element of speculation and chance is very small in the insurance business.

It is not true that the insuree is paid compensation out of his own contribution, firstly because the insuree is paid only on the occurance of a calamity; if the peril does not occur, he is paid nothing– thus the payment depends on mere chance, and secondly, because when the peril does occur, the insuree is paid out of the funds accumulated from fixed-earnings investment i.e., out of the interest earned from insurance funds. There is no mention in the insurance contract that each insuree will be paid compensation out of his own savings. If for a moment we agree with the suggestion that each insuree is paid

out of his own savings, then the further question arises; is the amount of compensation paid to the insuree always equal to the amount of his premium contribition? If not, then what is the relation between premium contributions of each insuree and his compensation? And in case of non-occurrence of a peril what happens to the so-called savings? Who grabs the saving and why it is not paid to the insuree.

Even if the insurance company has the knowledge and the means of calculating what it has to pay to the insuree in case of an accident or peril and what it has to take from him, the element of chance is always there. In spite of technical knowledge, modern methods amd statistical basis and the amount of compensation, the element of wagering can not altogether be eliminated from commercial insurance. In the words of Fetter, "The fact, however, that dealing in risks bring insurance in touch with other operations entailing risks, especially with gambling and speculation, have influenced the formation of the hazard theory which considers that insurance is like a lottery with dates and winnings of uncertain draws. A second definition of the hazard theory argues that 'insurance is another form of betting, but its essential purpose is the useful one of equalising and eliminating chance." (22)

People have tried to introduce some purpose and consequence in the insurance contract in order to make it look more meaningful and useful than mere gambling, but these attempts have failed to prove that the insurance business is free from the element of gambling or wagering. Barou argues, that "Even if the insurance contract could be described as a wager its significance is quite different from that of gambling. A man can pay £10 to an insurance company or to a bookmaker; in the one case he will get £500 if his house is burnt down, and in the other if his horse wins the race. The material result of both cases is the same, i.e., the receipt of £500, but the motives and effects are wholly different. The gain from betting increases the income and that means increased luxury, insurance resulting in compensation for the burned house, means prevention of distress due to the loss of his house. The real difference between insurance and gambing lies both in their purpose and in their consequence, in as much as insurance aims at neutralising and offsetting already existing chances and their consequences, and gambling specially and

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22 Fetter, ***Modern Economic Problems,*** pp. 180-1, quoted by Barou op. cit., p. 23-4;

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out in case of the loss, risk or death. It is no more than a co-operation.

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22 Fetter, ***Modern Economic Problems,*** pp. 180-1, quoted by Barou op. cit., p. 23-4;

purposely created new ones."

The insurance company is doing a professional job purely on business terms without any intention of neutralising or offsetting already existing chances of prevention of distress. It is not in the insurance contract nor is it the intention of the share holders of an insurance company to do any such thing. They are taking a risk like a gambler, it may benefit someone during this venture but this is immaterial to their main objective, i.e., to make profit out of this deal. And it is evident that the whole venture is based on an unknown risk, which may or may not occur; but the aim and nature of both the insurance company and the gambler is the same, i.e., profit.

9

Probability or Risk *(GARAR)*

The Arabic word ***garar*** means risk, hazard, danger, peril, etc. In business terms it means to undertake anything blindly without sufficient knowledge; or to risk oneself in a venture not knowing exactly what will be the outcome, or to rush headlong into a peril without regard to the consequences. In all these circomstances, the element of risk is present. According to Imam Ibn Taymiya *garar* is involved when one does not know what is in store for one at the end of a business venture or bargain. Every contract of an open-ended nature contains some element of ***garar.***

The concept of ***garar*** may be divided into two groups:

1. In the first group the element of peril or risk involving doubt, probability and uncertainty is dominant.
2. While in the second group the element of doubt due to the deceit or fraud on the part of one of the parties is paramount.

The Holy Qur'an has explicitly forbidden all business transactions including injustice in any form to any of the parties: it may be in the form of deceit or fraud, or undue advantage or peril leading to uncertainty in the business or any dealing. *(Qur'an*:6:151–152)

"He has enjoined that you should use full measure and a full balance. We charge you only with that much responsibility that you can bear."

This is a fundamental principle of the Divine Law, "You shall use full measure and a just balance." Allah has added, "We charge you" that "you can bear" to assure people that whoever tries his best to be just and right in weighing and carrying out other trade transactions, will be absolved of his responsibility and will not be taken to account. But those who do any commercial dealings merely to defraud other people of their rightful share are assured of the grave consequences of their deceitful acts on the Day of Judgement. Fraud must here be taken in a widely general sense covering all injustices in all levels of commercial dealings. (1)

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1. Maududi, op. cit.

This point is explicitly stated in the following verse of the *Qur'an*. (83:1-3
" Woe to those that deal in fraud – Do they not think that they will be ra
to account? On a Mighty Day." And again in ***Surah Al Nisa*** (4:29–30):

"O Believers! do not devour one another's property by unlawful ways; bu
business with mutual consent."

" Unlawful ways " include all the wrong ways that are against the Islamic La
and principles and are false and immoral. " Business " comprises all the
transactions that are carried on with profit, benefit, etc., as in tra
commerce, industry,etc.

"Mutual consent" implies that those transactions should be carried out
mutual agreement and not by coercion or fraud. For instance, althoug
apparently there is a mutual agreement in interest and bribery, yet it is obvio
that the needy party is compelled by circumstances to agree to su
transactions. In gambling, each participant is deluded by the false hope
"winning". No one would agree to gamble if they knew that they wo
The same is true in every transaction which involves fraud. The defrauded
party agrees under the misunderstanding that there is no fraud in it. If he kne
that he was being deceived, he would never agree to this." (2)

It leaves absolutely no doubt that dealings done with an intention to deceive
by one of the parties in a business transaction are forbidden by the Holy
Qur'an. There is also a clear prohibitory commandment of the Holy Prophet
with regard to fraud or deceit ***(garar)*** in business transaction.

First we will discuss the significance of ***hadith*** of the Holy Prophet relating to
garar, owing to doubt and probability and then owing to fraud and deceit.

1. Garar owing to doubt and Probability

(a) Sale of Fish in water

The sale of fish which is not yet caught is null and void as it is not in the state

2. Maudoudi, op. cit., p.118.

of property. In the same manner also, the sale of a fish which the vendor may have caught and afterwards thrown into a large pond from which it cannot be taken without difficulty is null and void, because there the delivery is impracticable.(3)

(b) Sale of a bird in the air

The sale of a bird in the air, or of one which after having been caught is again set at liberty, is null, because in the one case it is not property, and in the other the delivery is rendered impracticable.(3)

(c) Sale of a foetus in the womb

The sale of a foetus in the womb, or of the offspring of that foetus in null, because the Holy Prophet has prohibited it. (3)

(d) Sale of catch by a game-catcher

It is not lawful for a game-catcher to sell what he may catch at one pull of his nets, because the subject of the sale contains an element of *(garar)*. He may or may not catch any thing at all.

All these transactions and others of the same kind which contain an element of *garar* are forbidden by the Holy Prophet. In this type of transaction there is no guarantee that the seller can deliver the goods for which he receives payments, for the goods are neither in his possession nor has he complete control over this delivery. The bargain should be struck what is at present in the possession of the seller. What lies uncertain in the air, water, or in the womb of the future or what stands outside the possession of the buyer cannot be a commodity in a valid transaction in Islamic Law.

it is narrated by Abdullah bin Umar, Saeed bin Musayyib, Abu Hurairah and Ibn Abbas that God's Messenger forbade all transations containing the element of *garar*. (4,5,6)

3.*Hedaya*, op. cit., p.268.
4. ***Bukhari***, Vol.111. op.cit.,p.199 and ***Abu Daud***, op.cit.,p.634.
5. ***Muatta***, op. cit.,p.351.
6. ***Ibn Majah***, op. cit., p.154 and ***Abu Daud***, op. cit.,p.633.

According to Imam Ibn Taymiyah, *garar* is present in all those business dealings in which one party does not know what is in store for him at the end of the bargain. In other words, every contract of an open-ended nature contains some element of *garar*. Therefore one should try to avoid *garar* in all forms, in the price, quantity, or quality of the thing as well as in the time of delivery in business contracts where an exchange of goods, money, or some other consideration is involved. Everything must be clearly stated in the terms and conditions of the contract and no doubt or vagueness be left with regard to the price, quantity or quality of the goods or any other consideration under the contract. If any doubt or vagueness is found regarding any of these matters in the contracts, it will become void because of the presence of an element of *garar*.

Muslim jurists agree that the presence of *garar* in any business contract makes it invalid but they disagree on the matters relating to certain detais of the specification of quantity or quality in goods that may lead to *garar*.

Now let us examine commercial insurance and see if it contains an element of *garar*.

(a) Risk

A contract of insurance is made on risk in the sense that both parties to the contract are ignorant of the degree or limit of their obligations and responsibilities to each other. The insurer does not know the limit of his commitments or the happening of the peril, nor does he know how and when the peril will occur. Likewise the insured does not know how much and how long he will have to pay his premium instalments nor does he know the quantity of his gains on the happening of a peril.

Thus both the insurer and the insured are completely in the dark with regard to their commitments to each other because of the doubtful nature of the risk. The presence of an element of garar, therefore, is quite evident.

(b) Premium

There is no guarantee that the insured, who is paying the premium instalments

will pay his instalments for many unknown factors affect the decision of the insured as to whether to stop or to continue his payment.

An element of *garar* also exists in determining the amount of premium money as pointed out before. In spite of tremendous improvements in the techniques and methods of calculation of the degree of risk, the element of *garar* cannot be eliminated though it may be slightly reduced. So long as risk and other variables remain indeterminate and merely probable, the amount of premium will contain an element of *garar*.

There is an element of *garar* in all ventures involving risk, and commercial insurance is no exception. In order to determine the total amount of premium money of each insured, the risk and other variables involved are calculated. The amount of premium money of each insured will depend upon the risk element. The greater the risk, the higher the premium money which will obviously contain an element of *garar*, especially when the occurrence of the danger is not known.

(c) Indemnity

Indemnity, which is a form of guarantee against future risk, is also not free from the element of *gargar*. The insured does not know the amount of compensation he is likely to get in case of an accident or a peril. In fact there are quite a few unknown events. How much compensation will the insured be paid? When will he be paid? There is no definite answer to these questions. And if the peril does not happen, he may not be paid anything at all.

Sometimes the insurance contract is called an indemnity contract at a price. But it is not true because indemnity is not always paid. Even if the price is paid, compensation may not be paid in case of the non-occurrence of a peril. As such it cannot be called an indemnity contract at a price. It is only a promise to pay compensation which is sometimes fulfilled and sometimes not.

Again, indemnity must be differentiated from compensation. The insurance company pays an indemnity to the insured in return for premium money, but

in actual practice it is not an indemnity because sometimes compensation is more and other times less than the amount paid in premium money.

Furthermore, the payment of indemnity is dependent upon the payment of premium money. If the insured regularly pays his premium instalments, he will get his indemnity or compensation on the happening of a peril, but if he stops paying his instalments or pays irregularly, he may not get any compensation. This doubtful behaviour of the insured adds an element of *gargar* to the payment of compensation by the insurer. Thus *gargar* will always be present in indmnity.

(d) Insurable interest

The insurable interest, as already discussed, is of a very uncertain nature. What constitutes an insurable interest in the eyes of the law is very difficult to determine. A series of Acts made by the British Parliament, as explained before, have been passed since the beginning of the insurance business in Britain to cover and define insurable interest, but without much success.

According to the insurer " The possible loss must be accidental in nature and beyond the control of the insured. If the insured could cause the loss, the elements of randomness and predictability would be destryed." (7)

This shows that the very nature of insurable interest (or risk) demands that it should be accidental from the point of view of the insurer. As such, the element of *garar* is unavoidable.

Again, "from the point of view of the insured person, an insurable risk is one for which the probability of loss is not so high as to require excessive premiums.At the same time, the potential loss be severe enough to cause financial hardship, if a person does not insure against it. Insurable risk includes losses to property resulting from fire, explosion, wind storm,etc. losses of life or health; and the legal liability arising out of the use of an automobile

7. ***Encyclopaedia Britainnica,*** vol.9: 173–4 p.645.

occupancy of buildings, employment or manufacture." (7)

A cursory glance at the list of insurable risks from the viewpoint of the insured clearly shows that none of these can be accurately predicated. As a result, the element of doubt and hence, ***garar***, as to the extent of loss from the point of view of the insured will always remain a part of insurable interest.

2. *Garar* Due to Fraud and Deceit

(a) Sale of milk in the udder

The sale of milk in the udder is null, because there is the possibility of fraud. The udder may be void of milk, and full of wind, or there might be implicated in the sale something not properly the subject of it. Because of this the Holy Messenger prohibited it.

It is reported by Ibn Hurairah that the Holy Prophet said, " Don't keep camels and sheep unmilked for a long time, for whoever buys such an animal has the option to milk it and either to keep it or return it to the owner." (8) Abdullah bin Masud, Abu Hurairah, and Abdullah bin Umar reported God's Messenger as saying, " He who buys a goat (or a sheep) with its udder tied up has the option to return it within three days." (8,9,10). And Ibn Abbas reported that the Holy Prophet forbade the keeping of milk in the udder in order to deceive the buyer.(11)

(b) Najsh is forbidden

Allah's Messenger prohibited all bargains which contained an element of fraud and deceit or were transacted to defraud other people. One such sale contract was called Najsh. It was a kind of fraud in which one would offer a high price

8. ***Bukhari***, op. cit., p.201–2 and ***Muslim***, op. cit., p.801 and ***Tirmizi***, op. cit., p.578 and ***Abu Daud***, vol 111, op.cit.,p.45–46
9. ***Muslim***, vol.111. op. cit., pp. 799–801 and ***Tirmizi*** op. cit., p.578.
10. ***Tirmizi*** vol.1.op. cit.,.p.585 and 578
11. ***Abu Daud*** vol.111. op. cit., p.46 and ***Ibn Majah*** op. cit.,p.169.

for some thing without having the intention to buy but merely to ch
sombody else who really wanted to buy. Such a person would apparently ag
with the seller to buy the thing at a high price in the presence of the a
buyer in order to cheat him. The seller would falsely tell the buyer that he
previously bought the goods at a certain price which was in reality higher t
the actual price.

Ibn Aufa said that one who practiced *Najash* was a *Riba*-eating (interest-ea
traitor. "Such a practice is a false trick which is forbidden by the H
Messenger, who said, "Deception would lead one to Hell (Fire) and whoe
does a thing which is not in accord with our tradition, his act will not
accepted." (12)

It is narrated by Abu Hurairah that the Holy Prophet passed by a man w
was selling grain. The Holy Prophet put his hand in the heap of grain and fou
it wet inside, then he said, "One who deceives other people is not of us." (1
It is narrated by Ibn Umar, Abu Hurairah and Abdullah bin Dinar that t
Holy Prophet forbade *Najsh* (XXC 12,13,15). And it is reported by Ali th
Allah's Messenger forbade all sale contract and transactions including deceit o
fraud. (16)

Thus in all transactions involving fraud or deceit the buyer has the right t
return the article purchased to the seller and cancel the contract within three
days (or any reasonable time.)

Now let us examine commercial insurance in the light of the above discussion
and see if there is any fraud or deceit involved in it.

Some element of fraud is quite obvious in commercial insurance as the general

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12. Bukhari, Vol. 111 op. cit.. pp. 189-99 and *Mautta Imam Malik* urdu translation op. cit., p.359 13. *Bukhari,* Vol. III, op. cit.
14. Ibn Majah op. cit., p. 165 and *Tirmzi* op. cit., p. 601.
15. Muslim, op. cit., pp. 804-5.
16. Abu Daud, Vol. 11 op. cit., p. 635.

public is completely unaware of its terms and conditions. Most of the people are just drawn into it by clever agents and are quite ignorant of the consequences of their insurance policy, especially life insurance. "It is an axiom that life insurance is sold and not bought. In other words, the initiative lies with the seller. Unfortunately, in this country (i.e., Britain), almost anyone is free to sell insurance whether he knows anything about the subject or not. Thus, solicitors, accountants, bank managers, estate agents, commercial travellers and a host of others can acquire agencies with various life assurance companies which enable them to earn insurance commission as a profitable side-line. Whilst many companies claim to be strict in the standards they require of their agents, the facts belie this."

"Because life assurance brokers still have not fully recognised professional status it is the more difficult to choose between the good and the bad ones, bearing in mind that almost anyone with some knowledge of life assurance can set himself up as a broker and be recognised by the majority of companies'.(17).

And again in the words of W.L. Catchpole, "One of the findings of the now defunct Consumer Council's study of insurance in 1970 was that many policy holders had never read their policies, and those who had read them were unable to understand them. Although alarming to the council, these findings were hardly surprising. An insurance policy, with its complicated conditions can be a daunting document, and what adds to the difficulties is that each of the main branches of insurance represents a distinct and separate development within its own peculiar historical and legal background, it s own principles and practice, and its own policy wordings."

"In the light of these facts it is clear that the layman who sought to acquire a detailed knowledge of insurance in all its branches would be setting himself a formidable task which could keep him fully occupied for years."

The history of the British insurance industry bears witness to the fact that profiteering and exploitation have continued to disgrace the insurance business, with ever-increasing intensity. The development of legal measures since 1772 to

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17. Martin Paterson, ***Planned Life Assurance,*** London 1969, pp. 202-210

rectify the weakness of the insurance business have failed to achieve any tangible results. Some scholars have, therefore, called insurance business an "organised swindle". (19)

A glance at the lapses of insurance policies may, perhaps, give some indication of the story of fraud, deceit and exploitation in this business. "In the United States of America it seems that as many as 20 per cent of the ordinary branch policies lapse in the first two years. Reported lapses in the United Kingdom are not so high. Patrick and Scobbie (1969) estimated the rates of lapses in the United Kingdom (from a 1965 date supplied by five companies) to be 6 per cent in the first year, 23 per cent in the first five years and 33 per cent in the first ten years. Policies with small premiums tend to have a high lapse rate and most industrial branch policies in the United Kingdom appear not to reach maturity. If traditional life policies are surrendered in the first two or three years at most, only a small proportion of the premiums are returned." (20)

Insurance agents catch many innocent and ignorant people (especially members of the working class) into their net, by telling them fairy tales of insurance benefits. The majority of these people are absolutely ignorant of what they are going for and, consequently, fail to pay the premium money, often a few instalments. And when they realise that it is beyond their means, it is too late for them. If they withdraw in their first few years they get practically nothing, all their premium money is swindled on one pretext or another by the insurance companies.

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*18. **Business Guide to Insurance,*** London, 1974, pp. 11-12
19. Clayton, op. cit., pp. 254-272.
20. Stephen Wym, ***World Trends in Life Assurance*** London, 1975. p. 71

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The Element of Uncertainty *(Juhala)*

Juhala signifies an unspecified element in the quality, quantity or price of a thing. It seems something unknown or not known, leading to uncertainty in the outcome.

For example, when one of the parties to a contract says to the other, "I sell you one of my sheep for £10," this is likely to lead the argument and dispute from the very beginning because the specification of the sheep is vague and not known. The buyer would naturally ask for the best sheep in the flock, whereas the seller would like to give the worst.

(a) Sale with conjecture and Uncertainty

Any sale contract or business transaction which contains an element of uncertainty or conjecture *(Juhala)* is unlawful. There are many sayings of the Holy Prophet from Ali, Abu Hurairah and others which clearly forbade transaction of this nature. (1,2) Ibn Umar said that the Holy Prophet forbade selling a debt to be paid at a future date for another. (2) It was a common practice in Arabia during the Pre-Islamic period to allow a man who could not pay a debt when it was due to have an extension of the period in return for an additional sum payable. This species of transaction was forbidden by ***Allah's*** Messenger because it contained ***Juhala.***

The sale is invalid if any quantity of a commodity can only be judged by conjecture. It is therefore unlawful to sell dates (or any other fruit) growing on tree in exchange for dates which have been picked, and which are computed from conjecture to be equal in amount to those that are no the tree as

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*1. **Muslim,*** op. cit., p. 798; ***Ibn Majah,*** op. cit., p. 154, ***Abu Daud,*** Vol. 11 op. cit.,p. 633 and ***Tirmizi,*** op. cit., p. 568

explained under the section of gambling. This kind of sale contract was prohibited by the Holy Prophet. (3)

(b) Unspecified payment

If there is any ambiguity or uncertainty with regard to quality or quantity of the object of sale, its price or the time of the payment, the contract is invalid.

If the person purchases an article without specifically mentioning the quality or quantity he is going to buy from the seller, it may lead to uncertainty with regard to the sale transaction and bring in many other unknown problems on the part of both buyer and seller. It is therefore prohibited in Islam. A sale is not valid where the price is stipulated to be paid "on the return of the pilgrims" or " on the cutting of the grain", or "on the gathering of the grapes", or "on the shearing of the sheep" because in these cases the period is not absolutely determined. (4) Similarly, if an article is purchased without settling its price the sale is invalid because of uncertainty.

In fact, a sale contract is complete and valid when the article and the sale price are exchanged at the time of the sale contract, without any specification of quantity or amount. But the deal is not complete or valid, without the specification of the sum at the time of the contract. That is, "if, at the time of concluding the contract, the dirhams or dinar be not present, so as to admit of being referred to; in this case the general mention of them, without a specification of the numbers or the quality, is not valid; because the delivery of them on the part of the purchaser is requisite; and as general mention of them would occasion a contention between the purchaser and seller (the one wishing to give a few of a bad quality; the other insisting on a greater number and a better quality), the dealing would therefore become impracticable." (5)

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2. ***Mishkat Al-Masabih,*** Vol. 11 op. cit., p.611 and ***Abu Daud,*** Vol. 11 op. cit., p. 635
3. ***Hedaya,*** op. cit., pp. 268-9.
4. ***Hedaya,*** op. cit., pp. 274-5

However, a sale may be entered into either for ready money or on the specification of a promised time of payment. A sale contract is valid if the payment is made in cash or in the case of a future payment on the promise of a fixed period before payment, because this removes the element of uncertainty from the sale contract. This is allowed by the ***Holy Qur'an*** (2:282) and is supported by the action of the Holy Prophet who, having purchased a garment from a Jew and having promised to pay the price at a fixed future period, pledged his coat of mail for the performance of it.(5)

The purchase of a package of some goods is invalid, if the package contains more or less than the quantity agreed at the time of the contract. Likewise a sale is invalid, if the description of the goods which are the object of sale is misleading.(6)

In short, any type of transaction which leads to uncertainty with regard to the price (i.e., the amount of money) to be paid, or the quantity or quality of the object of the sale or the time of payment and the completion of the sale contract, is invalid. The price must be stipulated at some known and determined rate and the quantity and the time of the payment determined in clear terms because any doubt or uncertainty in any of these matters will render the contract void. (7)

There is no specific injuction in the ***Holy Qur'an*** with regard to this species of business transaction but a law is deduced from the following verse of the Holy *Qur'an* that the term for a debt or delayed payment must be clearly specified. If the terms in a future payment are not specified the sale contract will be null and void. The verse is as follows: " O Believers! when you enter into transactions involving future obligations for a fixed term you should put it in writing (2:282)."

This verse of the ***Holy Qur'an*** deals with transaction involving future payment or future consideration. For example, if goods are bought now (or any business transaction is signed now) and payment is promised at a fixed time

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5. ***Hedaya,*** op. cit., p.242.
6. ***Hedaya,*** op. cit., p.243
7. ***Hedaya,*** op. cit., pp.242–245.

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The purchase of a package of some goods is invalid, if the package contains more or less than the quantity agreed at the time of the contract. Likewise a sale is invalid, if the description of the goods which are the object of sale is misleading.(6)

In short, any type of transaction which leads to uncertainty with regard to the price (i.e., the amount of money) to be paid, or the quantity or quality of the object of the sale or the time of payment and the completion of the sale contract, is invalid. The price must be stipulated at some known and determined rate and the quantity and the time of the payment determined in clear terms because any doubt or uncertainty in any of these matters will render the contract void. (7)

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5. *Hedaya,* op. cit., p.242.

6. *Hedaya,* op. cit., p.243

7. *Hedaya,* op. cit., pp.242–245.

and place in the future. It is quite legal and valid provided the terms and conditions and the time of payment are clearly specified. If the terms and time of payment are not specified, the contract is invalid.

There are many sayings of the Holy Messenger which support this condition. The purpose of these instructions of the Holy Prophet was to make business transactions fair and eleminate the element of uncertainty from them as far as possible. It is narrated by Ibn Abbas that when the Holy Prophet came to Medina, the people were paying one, two or three years in advance for fruit (deates), so he said to them, " Whosoever pays in advance the price of a thing to be delivered later should pay for a specified measure and weight with a specified period. (9)

Abdullah bin Abi Auf and Adur Rahman bin Aliza said,"We used to get more booty while we were with Allah's Messenger and when the peasants of Sham (Syria) came to us we used to pay them in advance a specified price for wheat, barley and oil to be delivered within a fixed period. " (10) Ibn Umar and Jabir bin Abdullah reported that they used to buy heaps and heaps of grain from riders without weighing and measuring, and that the Holy Prophet " Forbade us from doing so". (8,11)

Imam Ahmad and Bukhari have narrated that the Holy Messenger told Othman, " Whenever you buy anything measure (or weigh) it and whenever you sell anything measure (or weigh) it. And the Holy Messenger said, " weigh your grain for it will be blessed ". (11) It is reported from Ibn Umar that if someone buys grain at a fixed price with a promise of delivery at some fixed date, the sale is valid." (12)

In all these examples of transactions involving future considerations (i.e.,

7. *Muslim,* op. cit., p.803.
8. *Bukhari,* vol.111op. cit., p.243–244 and *Muslim.*
9. *Bukhari,* vol 111.op.cit., p.249 and *Abu Daud,* vol.111. op. cit., p.53.
10. *Ibn Majah,* op. cit., p. 166–7
11. *Mauttq,*op. cit., p.343.
12. *Hedaya,* op, cit., p.299–300.

salam or *salaf*) the legality of the contract is conditioned upon specification of the price, weight, and time of delivery. If the bargain is struck without fixing the price, the weight or the period of delivery of the object of sale, the contract is void.

" Kandoori explains ***salam*** literally to signify a contract involving a prompt delivery in return for a distant delivery. In the language of the law it means a contract of sale causing an immediate payment of the price, and admitting a delay in the delivery of the wares."(13)

A *salam* sale is authorised and rendered legal by the following verse in the ***Holy Qur'an:*** "Do not neglect to reduce to writing your transaction for a specified period, whether it be big or small. Allah considers it more just for you, for it establishes evidence and lessens doubts and uncertainties among you. Of course, there is no blame on you if you do not put in writing the common, commercial transactions you conclude daily on the spot, but in case of commercial transactions you should have witnesses (2:282)."

This verse of the ***Qur'an*** allows cash deliveries on the spot without any conditions though it advises Muslims to have witnesses to their commercial transactions of this nature; but in the case of ***Salam*** sale (i.e., one involving future considerations) it lays down clear-cut conditions without which the sale is invalid. Briefly, the sale is subject to the following conditions according to the above verse of the ***Qur'an*** and the traditions of the Holy Messenger discussed earlier:

(I) A *salam* sale is lawful in all articles of weight (except monies) and measurement of capacity; because the Prophet has said,"Whoever enters into a *salam* sale with you, let him stipulate a determinate weight and measurement, and a determinate period of delivery." ***Dirhams*** and ***dinars*** (i.e. all monies), however, are not involved in the description of articles of weight, because both of these are representatives of price, and in a *salam* sale it is required that the

13. *Hedaya,* op. cit., p.299–300
14. *Hedaya,* op. cit., p.301–2

subject of the sale be otherwise than a representative of price. Hence if a person should enter into a ***Salam*** sale stipulating the immediate payment of ten yards of cloth to the seller in lieu of ten ***dirhams*** to be delivered to him by the seller at a future date, the ***salam*** sale so contracted is invalid. Some jurists have said that this sale is absolutely null."

" A ***Salam*** sale with respect to articles measured by length, for example, cloth, is lawful because it is possible to define them exactly by specifing the number of yards in respect of the length, breadth, quality, and workmanship. The recital of the specifications of these particulars, moreover, is requisite, in order to avoid ignorance and it is therefore essential to the validity of the contract. In the same manner also, a ***Salam*** sale is lawful with respect to all articles of sale which do not essentially differ in their nature, such as eggs and walnuts, because in all commodities which differ only slightly the rate is ascertainable, the quality definable, and the delivery to the purchaser practicable, and a contract of Salam therefore, with respect to such articles is lawful." (14)

(II) The period of delivery must be specified. "A *salam* sale is not lawful unless the period for the delivery of the wares be fixed. This is because the Prophet has ordained that all ***salam*** sales shall be made with the stipulation that period for delivery is fixed. Secondly, the Prophet has prohibited a man from selling what is not in his possession, but has nevertheless authorised and rendered legal Salam sale, on the principle that poor people stand in need of such arrangements in order that, by means of the money they receive in advance, they may acquire the subject of the sale, and deliver it to the purchaser. It is therefore requisite that a fixed period be stipulated, because if the seller were liable to an instantaneous delivery on demand, the requirements on which the legality of such sale is founded, would not be met. Moreover, an indefinite period is unlawful, because of the uncertainity; in the same manner as in a sale, where the price settled is to be paid at a future period without defining it." (14)

(III) Private standards of measurement are unlawful

The stipulation of a private measure of capacity or length is not lawful in a **Salam** sale, because of uncertainty due to possibility of the standard being lost in the interim between the conclusion of the contract and the delivery.

(IV) It requires that the genus be specified and that the kind, quality, quantity, and period of delivery, be all determined. A ***salam*** sale is not lawful except on the following conditions:

(i) The genus of the object of the sale is specified, such as wheat or barley of known quality or standard.

(ii) The quantity of it is fixed according to a standard weight or measurement of capacity.

(iii) The period of the delivery is fixed.

(iv) The amount of price to be paid advance is fixed.

In short, a ***Salam*** sale is valid where conditions concerning a general description of the quality and ascertainment of the quantity are fulfilled. Everything whose quality may be accurately described, where there is knowledge of the quantity, is a fit subject of a ***Salam*** sale, or where the sale cannot occasion contention. On the other hand, a ***Salam*** sale is not lawful with respect to things incapable of being defined by a description of quality or quantity because the subject of a ***Salam*** sale is a debt due by the seller; and if its quality is not known there consequently exists a degree of uncertainty, from which confusion must arise. (14)

This discussion on the injuction of the ***Qur'an*** and the ***Sunnah*** of the Holy Prophet clearly shows that the existence of ***Juhala*** in any business contract renders it null and void. Now we have to look at commercial insurance business in the light of this principle and see if there is any doubt or element of uncertainty ***(Juhala)*** in it. Even though each individual premium instalment the insuree has to pay is known, the total obligations involved in the insurance contract are not known to him. In spite of tramendous progress in actuarial techniques, it is not possible to estimate the total obligations of the insurance. In the words of Catchpole, " Insurance ratings take many forms, but however it is done, insuree can never forget that insurance differs basically from industrial and ordinary commercial activities in one vital respect; its cost is not known until after it has been sold – insurance by its nature, cannot estimate costs in the same way (as of industrial products), it can only hope to make an overall profit on a large number of separate risks."

subject of the sale be otherwise than a representative of price. Hence if a person should enter into a ***Salam*** sale stipulating the immediate payment of ten yards of cloth to the seller in lieu of ten ***dirhams*** to be delivered to him by the seller at a future date, the ***salam*** sale so contracted is invalid. Some jurists have said that this sale is absolutely null."

" A ***Salam*** sale with respect to articles measured by length, for example, cloth, is lawful because it is possible to define them exactly by specifing the number of yards in respect of the length, breadth, quality, and workmanship. The recital of the specifications of these particulars, moreover, is requisite, in order to avoid ignorance and it is therefore essential to the validity of the contract. In the same manner also, a ***Salam*** sale is lawful with respect to all articles of sale which do not essentially differ in their nature, such as eggs and walnuts, because in all commodities which differ only slightly the rate is ascertainable, the quality definable, and the delivery to the purchaser practicable, and a contract of Salam therefore, with respect to such articles is lawful." (14)

(II) The period of delivery must be specified. "A ***salam*** sale is not lawful unless the period for the delivery of the wares be fixed. This is because the Prophet has ordained that all ***salam*** sales shall be made with the stipulation that period for delivery is fixed. Secondly, the Prophet has prohibited a man from selling what is not in his possession, but has nevertheless authorised and rendered legal Salam sale, on the principle that poor people stand in need of such arrangements in order that, by means of the money they receive in advance, they may acquire the subject of the sale, and deliver it to the purchaser. It is therefore requisite that a fixed period be stipulated, because if the seller were liable to an instantaneous delivery on demand, the requirements on which the legality of such sale is founded, would not be met. Moreover, an indefinite period is unlawful, because of the uncertainity; in the same manner as in a sale, where the price settled is to be paid at a future period without defining it." (14)

(III) Private standards of measurement are unlawful

The stipulation of a private measure of capacity or length is not lawful in a **Salam** sale, because of uncertainty due to possibility of the standard being lost in the interim between the conclusion of the contract and the delivery.

(IV) It requires that the genus be specified and that the kind, quality, quantity, and period of delivery, be all determined. A ***salam*** sale is not lawful except on the following conditions:

(i) The genus of the object of the sale is specified, such as wheat or barley of known quality or standard.

(ii) The quantity of it is fixed according to a standard weight or measurement of capacity.

(iii) The period of the delivery is fixed.

(iv) The amount of price to be paid advance is fixed.

In short, a ***Salam*** sale is valid where conditions concerning a general description of the quality and ascertainment of the quantity are fulfilled. Everything whose quality may be accurately described, where there is knowledge of the quantity, is a fit subject of a ***Salam*** sale, or where the sale cannot occasion contention. On the other hand, a ***Salam*** sale is not lawful with respect to things incapable of being defined by a description of quality or quantity because the subject of a ***Salam*** sale is a debt due by the seller; and if its quality is not known there consequently exists a degree of uncertainty, from which confusion must arise. (14)

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" To calculate an equitable rate of premium for an individual risk underwriter has recourse either to the pooled record of risks of the same class his own portfolio, or in the wider record of a group of insurers. Having found the norm of the class concerned, he can adjust the rate upwards or downwards for favourable or unfavourable features in the individual risk to arrive at what considers a fair rate."

" In recent years past records have at times proved an unreliable guide to future patterns of loss experience. This change is due to three main causes:

(1) A high rate of inflation which has made claim costs rise faster than premiums;

(2) Changing methods and new materials which add to industrial risks and,

(3) Changing social values and standards of behaviour, leading to lower standards disciplines and personal responsibility." (15)

Thus the element of uncertainty is unavoidable in insurance and prevails at all levels of its business, from the time of the signing of the contract to the time of the paying of risk money to the insuree who has suffered a calamity. " The existence of uncertainty is the fundamental condition for the existence of insurance. The uncertainty can be of three kinds. Firstly, it may be uncertain as to whether the occurrence will really happen; secondly, whether it will happen during a given period of time; and thirdly, it may be uncertain as to the dimension of the occurrence. Thus, it can be an uncertainty of occurrence, of dates or of dimension. Uncertainty is the state of mind of the individual which corresponds to the degree of probability of an occurrence (or chance) in the objective situation; therefore, uncertainty becomes a sequel of probability." (16)

Even though an increase in the number of insurees may reduce the degree of probability, the element of uncertainty will still remain in the insurance business to a considerable extent. The probability in relation to many phenomena may

15. W.L. Catchpole, ***Business Guide to Insurance,*** London, 1975,p.26.

16. Seligman, ***Principles of Economics,*** p.599, by N. Barou, *Co-operative Insurance,* London, 1936.p.14–15.

readily become predictable in groups of sufficient sizes, but still a number of risks may cause uncertainty as to the general average. Uncertainty will always remain a prominant factor disturbing the estimates and calculations of clever acturial experts. And it applies to the premium money as much as the amount of compensation, the meaning of the insurable interest or the time and the dimension of the peril.(17)

Summary

The views of the Muslim jurists on the subject of ***garar*** and ***juhala*** are summarised as follows:
Garar and *Juhala* are of three types:
(a) When goods contracted are not delivered , (b) When goods contracted are partially delivered, and (c) when a greater part of the contracted goods is delivered. According to Ibn Al-Waleed these can be calssified: (a) As too much, (b) moderate, and (c) too little.

The first and second (i.e. a and b are definitely unlawful because of the element of ***garar*** and ***juhala*** but he last (i.e. c) where the element of ***garar*** and ***juhala*** is too small, is controversial.

There is some difference of opinion among the Muslim jurists as to the ratio of ***garar*** in a specific contract which could be called too little. However, they all agree that the following forms of sale contracts are unlawful because of the presence of ***garar*** and ***juhala:***
(i) A sale of goods not yet made,
(ii) A sale of goods not yet in the possession of the seller,
(iii) A sale of fruit not yet ripe,
(iv) A sale of products that cannot be easily given or taken possession,
(v) A sale of unspecified (in price, quantity or quality) goods,
(vi) A sale of goods with an advantage to one party.

This presents us with a good example of certain forms of sale contracts not lawful in Islam because of the element of ***garar*** and ***juhala***. Any contract of sale

17. Devenport, ***The Economics of Enterprise,*** p.404–5, quoted by Barou, op. cit., p.14–15

or exchange of goods, money, or other considerations containing these elements will be considered invalid and unlawful. The sale or exchange of contracts of the sort cited above were prohibited by the Holy Prophet.

It is true that Muslim jurists have deffered on matters relating to specification of goods with regard to quantity and quality and have also disagreed about the details of certain specific sale contracts, but fully agree that if there is *garar* or *juhala* in any business transaction it invalidates the sale contract.

It may be pointed out here that when discusssing cases of *garar* and *juhala* in business transactions, it is not proper to quote examples from the *sunnah* of the Holy Prophet relating to purely religious matters or to good deeds performed for the pleasure of Allah. In such cases *garar* or *juhala* does not come into question because they are either good deeds and acts of faith and not business transactions; or they are purely religious ceremonies or acts where the main objective is not financial. If there is some vagueness or probability in any of these matters it will not in any way affect the nature of the act because it is a religious act and it excludes money matters. whereas if any doubt, vagueness or uncertain element (like *garar* or *juhala)* is left in a sale contract or a business transaction, it will lead to many complications, disputes and contentions among the parties.

The supporters of insurance therefore claim that the presence of an element of *garar* (or *juhala)* in insurance will not render it null and void because it does not lead to disputes and disagreements. In other words the basic factor which invalidates a sale contract according to them is not pure garar but garar that leads to disputes among the people.

This reasoning is irrelevant and superfluous. The fact is that this sort of contract and transaction was very common in the pre-Islamic period and was deep-rooted in the economy of that time. It was therefore not easy to stop them. As Islam spread up and down the country in the peninsula of Arabia and its basic teachings began to take root in the hearts of the people, the Holy Prophet gradually in the last years of his ministry started to purify the economy of its evils and unlawful customs and dealings. This is how this particular sale contract, when brought to the notice of the Holy Prophet, was

declared illegal. To all appearances, the dominant factor seems to be the dispute and disagreement of the parties and the element of ***of garar*** is in the background.

A layman can only detect the external symptoms of the disease on the face of a patient who is sick and red with fever and fails to notice the internal disease which is the basic cause of the fever. The doctor will try to cure the patient by removing the internal cause of the fever while the layman will be thinking only of the fever. This is what happened in the sale of fruit. The Holy Prophet tried to cure the root cause ***(garar)*** of the external disease (i.e. disputes) by prescribing medicine for the former while the people thought otherwise. It is therefore quite wrong to think that if there are no disputes in any business transaction (like commercial insurance) the presence of ***garar*** will make it lawful. The basic cause of the external evils in the economic transactions of the people were ***riba***, ***maisar***, ***garar*** and ***juhala***; and the wisdom of the prophethood rightly detected the real cause of ***fasad*** (corruption) in the economic system of that time and made it unlawful. It can be said without doubt that what was true in those times is true and fully applicable to our time (and future times) as far as these unalwful elements are concerned because most of the economic evils which corrupt society are generated by them.

11

EXPLOITATION AND UNFAIR DEALINGS

Islam is on the side of justice and fair paly in business dealings for all parties and forbids unfair transactions and the exploitation of people. It does not support the view that all is fair in business. On the other hand, it insists on justice and fair play in every kind of commercial dealings and all bargains that are made without being given an opportunity to the buyer to examine the terms of the contract or the object of sale are prohibited. Forcible transactions or dealings in which either of the two parties takes undue advantage of the other are also forbidden.

*In the following verses of the **Holy Qur'an** the believers are told to do business dealings by mutual consent and not to devour other people's wealth by unfair and unlawful means. " O believers! do not devour one another's property by unlawful ways; instead do business amongst you by mutual consent. And do not kill yourselves.(4:29)*

This verse clearly shows that all transactions are forbidden which are meant to exploit , favour or take undue advantage of either of the parties in the contaract. " Do not kill yourselves " is a painful reminder that the one who devours unlawfully the property of the others , does in fact lead himself to his own destruction. for such an evil deed ruins the social order to such an extent that ultimately he himself cannot escape its evil consequences. (1)

And again in ***Surah Al-Baqarah:*** Do not usurp one another's property by unjust means nor offer it to the judges so that you may devour knowingly and unjustifiably a portion of the goods of others.(2:188) . This verse has two aspects. One should not try to seize the property of others by bribing the judges and one should not go to the court of law to seize the property of

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1. ***The Meaning of the Qur'an,*** Abul Ala Maududi, Vol. II, p. 118

others through lengthy and false arguments. It is just possible that the judge might decide, on the basis of available evidence, in favour of the transgressor, but it does not mean that the property has thereby really become lawful for him. The Holy Prophet warned such people saying, "After all I am a human being. It is just possible that in a case brought before me, one better versed in the act of talking than his opponent might persuade me to decide the case in his favour. But let it be understood that anything gained in this way from a brother will, in fact, mean the acquiring of a piece of Hell for himself in spite of my decree in his favour." (2)

"Abdullah reported that some people used to buy foodstuffs outside the town from the caravan people and used to sell it on the spot. Allah's Messenger forbade them to sell it till they brought it to the market." (3) "According to Abu Hurairah, Ibn Umar and Ibn Abbas Allah's Messenger said, "Do not meet the merchant in the way and enter into business transaction with him, and whoever meets him and buys from him (and in case it is done, see) that when the owner of (merchandise) comes into the market (and finds that he has been paid a lower price) he has the option (to declare the transaction null and void".) (4,5)

This step was taken by the Holy Messenger to safeguard the interests of the seller as well as the general public (i.e., the commoners). The goods should be bought in the open market where the sellers can be fully acquainted with the conditions of the market. This would insure that the sellers are not taken unawares, and secondly that undue advantage in not taken of the buyer's ignorance by the sellers or their agents. This would also guarantee a reasonable price for the consumers and would protect them from the exploitation of the black-marketeers and hoarders.

Likewise the Holy Prophet also prohibited unfair brokerage to safeguard the

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2. M.A.A.Maudoodi, op. cit., Vol. 1. p. 143
3. ***Bukhari***, op. cit., p. 208.
4. ***Muslim***, op. cit., pp. 799-800, ***Mautta***, op. cit., p. 359, ***Ibn Majah***, op. cit., pp. 148-9 and ***Tirmizi*** op. cit., p. 565.
5. ***Mishkat***, op. cit., p. 609 and ***Abu Daud***, Vol. 111, op. cit., pp. 43-4. ***Ibn Ibn Majah***, op. cit., p. 148 and ***Tirmizi***, op. cit., p. 565.

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interests of all the parties affected by such dealings. "Abdullah bin Umar, Jabir, Anas bin Malik, Ibn Abbas and Abu Hurairah reported that Allah's Messenger forbade the selling of the goods of a desert dweller by a townsman." (5,6,7)

The purpose of this prohibiting order was that goods and commodities for sale should come into the open market, where sellers or their agents were fully aware of the state of the market before any offer of purchase was made by the sellers.

The insertion of any favourable conditions for one of the partners in contract also renders the sale contract null and void.

A sale is rendered invalid by the insertion of any conditions advantageous to either party, or repugnant to the requisites of the contract; or which may occasion contention by involving an advantage to the subject of the sale. The insertion of any condition which is not a necessary result of the contract, and in which there is an advantage either to the buyer or the seller, or to the subject of the sale, or capable of enjoying an advantage renders the contract invalid, because an additional and extraneous act is, in this instance, required from any of the parties, without stipulating a recompence to the other, and which of consequence is of usurous nature; and also because there is an advantage in this condition to the subject of the sale, it follows that a contention must necessarily ensue and hence the object of sale is frustrated." (8)

Likewise, "a sale is rendered invalid if there is a reservation of any advantage to the seller concerning the article sold. For example, if a person was to sell a house on condition that he shall reside in it. Firstly, because these conditions are not agreeable to the nature of a sale, and are attended with an advantage to

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7. ***Bukhari,*** op. cit., p. 202 and ***Tirmizi,*** op. cit., p. 585.

the seller. Secondly, because the Prophet has prohibited a sale on condition of a loan; and thirdly, because if any concession is made in the price on account of the object of sale (i.e. residence in the house), it follows that a contract of rent is interwoven with that of the sale. If, on the other hand, no diminution is made in the price on this account, it follows that a deed of loan is interwoven in the sale, and both of these are illegal." (8)

There is no need to repeat the arguments supporting the claim that an element of exploitation does exist in insurance as the matter has already been discussed in great length under the section called 'Uncertainty'. Undoubtedly there is considerable exploitation and unfair treatment of the insuree in the contract of insurance due partly to the ingnorance of the insured party to the complexities of the insurance policy, and partly to the infringes and uncandid behaviour of the host of insurance agencies.

Even the 'supporters' admit that the function of the organisation of commercial insurance is likely to lead to hoarding or manipulation of funds but argue that it is not a part of the insurance function or the insurance contract. But they forget that the hoarding and manipulation of funds for profit has become the main function of commercial insurance in the modern industrial world. Huge funds collected from premiums and lapses of policies are invested in fixed-earning investments (i.e. interest) and form the main source of their income. It is only natural that such manipulation of money for profit should follow from the working of insurance business.

It is suggested that individual insurees have to demand from the insurance company the proper use of their money, avoiding unlawful elements like interest *(riba)*, etc. But this suggestion is absolutely ridiculous because individual insurees are as helpless as small boats on a stormy ocean. How can they influence or demand such actions from the gaint insurance companies? perhaps the 'supporters' are confusing giant insurance companies with co-operative or mutual insurance societies. This is possible in the case of the latter which are organised and controlled by the insurees themselves and are working for their benefit, but it is not feasible in the case of the former which are controlled by and in the interests of the share-holders.

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8. *Hedaya*, op. cit., pp. 273-74.

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The individual insuree is in a very weak position as compared to the [illegible] commercial insurance companies, and is not in a position to dictate, or even demand such terms from them. He has either to accept or reject the [illegible] terms of the insurance contract. He is unable to suggest or recommend any amendments in it. This may be claimed theoretically as a means of participation of the insuree but it is not a practical proposition in view of the helpless position of the individual insuree. As a result, exploitation, manipulation and other similar malpractices and unlawful activities have become part and parcel of commercial insurance. Verbal suggestions cannot change facts in the field of commercial insurance. Failure of successive Acts of the British Parliament to achieve the desired results should be an eye-opener to 'supporters' of commercial insurance.

The great majority of the people are absolutely ignorant of the rules and regulations of insurance and the obligations of the insurees with respect to the insurance contract. Many of them are clearly tricked by cunning brokers or insurance representatives into under- taking it. The great number of lapsed insurance policies in the first two to three years of the contract bears witness to this fact. And also because "it has often been said that this (i.e. the insurance policy) is never bought but always sold (in other words) the persuasive words of a life office representative, a broker or an agent are necessary if people are to be made aware of the advantage, if not the necessity, of life cover." (9)

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9. Naylor, Margot, ***Truth about Life Assurance,*** London, 1971, p. 174

12

THE ELEMENT OF PROBABILITY IN LAWFUL CONTRACTS

Some have tried to defend commercial insurance as a perfectly valid business in the Islamic system. They emphasise that commercial insurance is a form of trade involving an exchange of goods or a consideration based on the contractual obligations of the parties which are implicitly written and explained in the insurance contract. The idea behind all forms of trade is profit or the growth of capital and commercial insurance is no exception. It is organised to provide service in the form of indemnity to those who have suffered a loss. And in this exchange, insurance companies may make profit like any other trade. It is therefore quite valid and lawful and there is no reason to call it unlawful.

But commercial insurance does not come under this category and cannot be considered as a form of trade or an ordinary business because it does not give anything tangible to the insuree in return for his premiums. It is only a promise depending on the happening of an event which may never happen at all. The insuree pays certain sums of money to the insurance company in exchange for possible and uncertain compensation, and in the case of the non-occurance of the possible danger, no exchange of goods, services or consideration takes place. Thus, it is an exchange of money on the part of one party, i.e. the insuree, but the other party's exchange is uncertain. It cannot, therefore, be called a legitimate exchange of goods.

Moreover, an exchange of goods, services or some other consideration should be done with material consent and consultation between the parties. As has been pointed out before there is no such thing in commercial insurance. The insuree is in a very weak position and has no option, but to insure with one of the companies on their own terms and conditions, which are predetermined by a third party and are not negotiable. Therefore, it is mere farce to call insurance business as form of trade.

The supporters of insurance accept that there is an element of risk in insurance which leads to *garar* (or *juhala*) but they argue that there are many lawful contracts allowed by *Shariah* which contain an element of probability and uncertainty (*garar* and *juhala).* They claim that the element of *garar* (or *juhala*) in commercial insurance is not so great as to make it lawful.

The supprters give many examples, from commercial as well as non-commercial transactions, to show that commercial insurance is not very different from any normal transaction. First we will discuss non-commercial examples.

1. *Kafala* or *Zaman* (Bail or Guarantee)

" In the language of the law, *Kafala* (bail or guarantee) signifies the function of one person to another in relation to a claim or a debt. A person who renders obligatory on himself, the claim of another, whether it relates to the person or property, is called the *Kafeel* or surety."(1) " It is allowed by *Shariah* because the Holy Prophet has approved it. He has said,'the surety is responsible' which is a proof that both modes of bail (of person or property) are lawful. *Kafala* of the person or property is valid in Islam. In the case of property, whether the extent is known or unknown, *kafala* is lawful. *Zaman* signifies surety or security, if a person becomes security on behalf of another for a debt due by him, he is his *zamin* or the gaurantor. All such securities are valid." (2)

It is claimed that *kafala* and insurance are almost identical because the extent of the obligations and liabilities in both are not known. *Kafala* is allowed by *Shariah* and there is no reason why one should be valid and the other invalid when both are identical with the main commitment being money and lending it is also said that *Zaman* (security) or the standing of surety for someone contains unknown elements. One cannot be sure how much one has to pay. Even when the extent of the debt is unknown and unspecified it still is lawful. The case of commercial insurance is strengthened by the validity of bail.

Kafala or *zaman* is in the nature of gratuious act of justice and goodness and is

1. *Hedaya*, op. cit., p. 317–18
2. *Hedaya*, op., cit., p. 320–328

performed to seek the pleasure of Allah. It does not involve any monetary consideration on the part of the ***kafeel*** or ***zamin*** and therefore belongs to a different class. Thus standing guarantee for someone's debt or loss is based on different principles and has no relevance to the problem of commercial insurance. It is an extension of the principle of goodly loan *(Qarz-e-Hasan)* to help in need and can, under no circumstances, be quoted to justify commercial insurance. It is a moral duty and obligation upon a Muslim to help his brothers in faith.

Thus, one is a good deed and an obligatory duty without any financial consideration while the other is a purely commercial transaction transacted for profitmaking. The nature and extent of a good can hardly be identical with a purely commercial transaction (like insurance). As such, the two forms of contracts , which are not of the same class, cannot be compared with each other. And if it is done, the conclusions drawn, would be arbitrary and fallacious and would have absolutely no bearing on the problem under discussion.

It may, however, be pointed out that even in surety, the jurists demand specified and definite liabilities. Hanafis insist that the amount or liability against surety must be a known quantity (i.e. specified).

2. *Mawalah* (Friendship)

The root of ***mawalah*** is ***'willa'*** which literally means assistance and friendship. In the language of the law, it signifies that mutual assistance which is a cause of inheritance . ***Mawalah*** thus refers to the contract of ***mawalah*** between two persons who form a mutual patronage or clientage.

This patronage is formed when a stranger says to the person who converted him to Islam, or to any other persons, " I enter into a contract of ***mawalah*** with you, so that if I die, my property shall go to you, if (on the other hand), I commit an offence, the fine is upon you or your ***'akila'***. The person thus addressed agrees and in consequence he becomes the ***'mawlah'*** of the stranger.

3.*Hedaya*, op., cit., p.517

Upon his death, without heirs, he inherits his property, but according to Shafei, it does not occasion inheritance in any respect as it tends to annul the right of the public treasury.(3)

The supporters of commercial insurance emphasise that *mawalah* is almost like commercial insurance with element of *garar* (or *juhala*) and is valid. The ***mawlah*** who enters into such a contract is completely in the dark as to the extent of his liabilities. He may run into any sort of liabilities, the nature and extent of which is totally unknown . This contract, with all its unknown quantities, is allowed by Muslim jurists.

There is no truth that commercial insurance is similar to *mawalah* with respect to the element of ***garar*** and ***juhala.*** The early form of *mawalah* practiced by the companions of the Holy Prophet was a simple voluntary contract between two individual believers for cementing their relationship in faith and for assisting each other without any profit motive, whereas the former is a commercial institution organised to make profit out of other people's needs and weakness.

Mawalah is a personal contract between two individuals based on the principle of equality and mutuality, whereas the insurance contract has no personal element in it, nor it is based on the principle of equality and mutuality. The one is formed to seek the pleasure of Allah and is an act of goodness and the other is formed merely to make profit. As the Holy Prophet has said," The relationship of ***'willa'*** is like the relationship of consanguinity." As such, it cannot be compared with commercial insurance because it has the element of assisstance." And as the Arabs were accustomed to assist each other in various ways, and the Holy Prophet interpreted such mutual assistance into *'willa'* as a class on its own.

3. Agency

" It is lawful for a person to appoint another as his agent, for the settlement on his behalf of every contract which he might have lawfully concluded himself, such as sale, marriage ,etc. But when a person appoints another as his agent for purchasing some indefinite thing, it is necessary that he should explain what it is and its quality and price in order that the agent may know

the nature of the act for which he has been appointed and thence become capable of executing it. However, an agency is invalid where the terms in which it is expressed, leave a great degree of uncertainty with respect to its subject. (4) The agency in this case, because of the great degree of ***garar*** and ***juhala,*** becomes impracticable. The presence of these elements make the agency invalid. Therefore, it is wrong to suggest that commercial insurance, having many unknown elements, is a valid form of business.

The 'supporters' point out that the insurance company acts as an agent of the insuree and as such , is quite lawful. Even if it is admitted as an agent of the insuree or insurees, it cannot be recognised as doing a lawful business, because the terms of the insurance contract leave a great degree of uncertainty with respect to the subject of indemnity and the probable event.

In fact, the basis of the agency in this case is missing and such a contract of agency is unknown to ***shariah*** because a valid contract of agency must possess the following:

(i) The agent is freely appointed by the employer.

(ii) The agent works for and in accordance with the instructions of his employer and not for seeking profit for his own sake.

(iii) The agent works in the interest of the employer and not against his interest.

Obviously, the agency of insurance company is not created by the insuree of his own free will, nor does it work for and in accordance with his instructions for his interest, but works for seeking profit for its own shareholders.(5) Besides this, the insurance company has claimed that it works as an agent on behalf of each individual insuree or insurees as a group. And there is no mention of this kind of function, i.e. 'agency' either in the rules of the insurance company or in the insurance contract.

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4. *Hedaya,* op., cit., p.376–8

5. *Hedaya,* op., cit., p.379–80

4. Mortgage (or *Rahn)*

It is said that insurance company is like a mortgagee and is holding the [illegible] until it is paid back to the insuree on the happening of an event.

In the language of the law, *Rahn* means the detention of thing on account [illegible] claim which may be answered by means of that thing, as in case of debt [illegible] lawful and is ordained in *the Qur'an:* " Give and receive pledges." The [illegible] Prophet , in a bargain made with a Jew for grains, gave coat of mail in [illegible] for the payment. It is approved by all the jurists and is lawful in the [illegible] manner as bail."(6)

" But it is not lawful for the pawnee (i.e. mortgagee) to enjoy, in any [illegible] benefit of the pledge, for the right of the pawnee is in the possession, and [illegible] in the use. He is not entitled to lend or let it to hire; for a pawnee is [illegible] permitted to let out or give the pledge in loan, for, as he is himself prohibited from its use, he consequently is not authorised to confer its use upon [illegible] (7).

If these conditions of mortgage (or *Rahn*) are not observed, the contract of mortgage becomes void. In the contract of insurance, none of the conditions are observed by the insurer. The insurer invests the monies obtained from the insurees in premiums in any way he likes and makes huge profits for the shareholders. These profits are never returned to the insurees.

If we admit for the sake of argument that the insurance company is like a mortgage, it should, in that case, return the actual amount to the insuree, but it is not always returned to him, especially in the non-occurrence of the peril. What does holding the pledge mean for the insurance company? In this case what is the object of such a pledge? and even when the money is returned on the happening of an event, it is not always equal to the amount paid in premiums.

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6. *Hedaya,* op., cit., p. 630
7. *Hedaya,* op., cit., p. 633

Again, the fact that the insurance company is a mortgagee is neither mentioned in the rules of the company nor in the insurance contract. It is a mere fabrication of the supporters of the commercial insurance.

5. Trusteeship or Deposits *(Wadaa)*

It is also said that the insurance contract is a form of trusteeship deed between two parties, the insurance company and the insurees. Instalments in the form of premiums are collected by the former from the latter as their trustee and paid back to them in the from of an indemnity according to the terms and conditions of the contract.

" *Wadaa* or trusteeship, in the language of the law, signifies a person empowering another to keep his property. A deposit remains in the hands of the person who receives charge of it, as a trust; that is to say, he is not answerable for it; because the Holy Prophet has said," an honest trustee is not responsible" and also, because deposits are necessary ; and this necessity could not be answered in case of making trustees responsible, as no one would then accept the trust." (8)

If a trustee transgresses with respect to the deposit, by converting it to his own use or by committing it to the care of another person, he is responsible for it. It is absolutely ridiculous to compare an insurance company with a trustee. This relationship is neither known to the parties concerned nor it is written down in the insurance contract, and no one has ever claimed this relationship excepting the 'supporters' of commercial insurance. The insurance company has an agreement with each insuree and this is the basis of modern commercial insurance. It does not claim any such relationship . Thus, this relationship has no basis either in the constitution of the company or in the insurance contract.

The relationship between the trustee and the depositor is based on the spirit of frindship and does not involve any financial consideration. It is considered a gratuitous act of goodness to help people by accepting their deposits without any reward; whereas , in commercial insurance,the whole business is organised

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8. *Hedaya,* op., cit., p.471–2

to make profit. In case of trusteeship, the exact amount or quantity of the deposit is paid back on demand which is not the case in commercial insurance. What about the insurees who are never afflicted with a calamity? They never receive their deposits from the insurance company whereas a trustee is bound to return the deposit entrusted to him. If the insurance company is a trustee, how and on what grounds does it withhold the 'deposits' of its insurees? There is no *Garar* or *Juhala* in a contract of trusteeship whereas commercial insurance is not free from these elements.

How can there be any relationship of trusteeship between the insurance company and the insurees? There is complete conflict of interests between the parties; the interest of the former is to make the maximum profit out of the deal, whereas the latter likes to get the maximum compensation from the former. At no point is there any mutuality of interest between the parties.

Besides, all funds deposited with the insurance company are the property of the shareholders of the company and each individual insuree or all insurees as a group have absolutely no legal right of ownership or control over their individual deposits, or the total funds of the company; nor can they claim their deposits individually or as a group after the signing of the insurance contract just as one can claim his deposit whenever one likes from the trustee. This is the basic right of the depositor in a trusteeship that he can demand his deposit whenever he likes and the trustee has to accede to his demand; this is totally denied in an insurance contract.

A trustee is not held by the law to be liable for responsibility. If he is held responsible, it would be contrary to the precepts of the law. In other words, a condition of responsibility is null and void with respect to a trustee. If the premiums are held by the insurance company in the nature of a trust, and a trustee is not held by the law to liable for responsibility, as such, a condition of responsibility for the payment of compensation to the inflicted insuree with respect to an insurance company is null. Hence, the analogy of trusteeship with respect to commercial insurance is neither applicable nor true.

6. Loan

It is said that premium money is like a loan taken by the insurance company

from its insuree and, therefore, valid. There is some element of uncertainty with regard to the payment of the loan like that of insurance, but it does not affect the validity of the contract. This applies equally to a loan as well as to insurance.

"A loan signifies an investiture with the use of a thing without a return. A loan has two objects - the use of the article, and the restitution of the substance. Such a loan is lawful, as being a sort of kindness, because ***Allah*** has commanded His servants to, "Do kindness to each other," and also because the Holy Prophet borrowed a suit of armour from Sifwan."

Justification of insurance cannot be sought from a gratuitous loan which is an act of kindness performed in obedience to the Command of ***Allah*** and for His Pleasure. There is no financial consideration involved in such an act of goodness, whereas profit-making is the main purpose of the commercial insurance. Thus insurance contract is quite different from a loan. Besides, a loan requires full restitution of the subtance which is not forthcoming in an insurance contract. The premium money is rarely paid back in full on the happening of an event. And in non-occurance of a danger, nothing is paid back.

Furthermore, it is not lawful for the insuree, who is the lender, to benefit from the insurance company, which is the debtor. The Holy Prophet forbade people to draw benefit from a loan. Thus, the suggestions that the insuree is like a lender to the insurance company cannot be accepted for it is not lawful for the lender to draw any benefit (in the form of compensation, etc.) from his debtor. It is, therefore, inappropriate to give the analogy of a loan to validate an insurance contract.

7. *Nikah* or Marriage

It is argued that an element of ***Garar*** is present in the contract of marriage for one cannot know how much expense will be involved. One does not know the total expense one may have to spend on his wife and children. No specific amount can be given at the time of marriage. Therefore, the 'supporters' insist that if marriage contract with an obvious element of ***Garar*** is valid,

insurance with less, or even a degree of uncertainty, should also be valid.

As has been pointed out before, comparisons of religious observances, acts of goodness or other acts not involving financial consideration with commercial insurance, are not relevant because the latter is not of the same kind. Commercial insurance is purely commercial institution and operates mainly for reasons of profit, its activities, (i.e. insurance business) cannot be compared with the contract of marriage, which is a religious contract free from monetary considerations. Therefore, the comparison with commercial insurance business is invalid.

8. Prize Money

It is said that prizes or rewards for invention, especially projects or discoveries are approved by the jurists. When some one says that he will pay £10,000 if someone could do this or that, the amount becomes due as soon as the utterance was made and thing was done. In respect of prize money the following verse of the Holy *Qur'an* is quoted: "Whoever will find it, I guarantee that he will get a camel-load of corn (12:72)".

It is ridiculous to justify commercial insurance by comparing it to prize money or to the case of reward offered by Prophet Yusuf quoted above. These are simple and straight forward examples of prizes or rewards offered for doing something or finding something which have no connection whatsoever with the commercial insurance. There is neither any risk nor any element of *Garar* or *Juhala* in such cases. Some commercial dealings are also quoted by the 'supporters' to justify commercial insurance business.

1. Hunting and Diving for Pearls

The element of risk is obvious, both in the contract of hunting as well as diving for pearls in the sea. Probable loss in both is quite apparent. Who knows the outcome? Thus,the basis of the contract is unknown and unspecific in these two contracts, but both of them are allowed by *'Shariah'*.

A cursory glance at the two forms of contracts will show that they are simple

contracts between two individuals for a specific and definite purpose, while insurance contract is between one helpless individual and a joint company involving the multiplicity of such contracts. It is therefore illogical and irrelevent to compare the former two contracts with an insurance contract.

Most of the people who hunt do so for pleasure and catch is a bonus for them, it is only a one-party activity and does not come into the category of an ordinary trade transaction. Therefore, the question of *Garar (or Juhala)* does not arise in this case. Even if there are some cases where one party engages another party for this purpose, the terms or the price of each catch or the whole hunting trip are precisely known to the parties and there is no vagueness with regard to the reward of the hunter. When there is no catch, both parties get nothing, except the pleasure of hunting.

2. Night Guard or Keeper of a Garden

Shariah allows for the engaging a night guard or a caretaker to look after or safeguard property in return for a specified wage (or salary) per day, week or month. What does the owner of the property get in return for a specified wage? Mere assurance or promise of assurance against thieves and tresspassers. How can one justify engaging a guard or caretaker for mere promise against tresspassers while rejecting insurance where payment of indemnity is promised in return for premium?

Again, it is a simple contract between two individuals for a specific purpose in return for specific and known compensations without involving the multiplicity of contracts by one intermediary with thousands of insurees with an unknown element or risk liability. The property of the owner is protected and safe-guarded against vandalism by thieves and trespassers. If it is not safeguarded against such hazards it is likely to be demaged by tresspassers and thieves. The guard or the caretaker, therefore, performs a positive and precise duty for the owner of property in return for his wages. Likewise is the case of a garden keeper and hiring a thing or a man for a price.

3. Feeding a baby

The feeding of a baby by a woman other than the mother in exchange for the

promises of unknown quantities of food and clothing is lawful (*Qur'an*: 2:[illegible]). "The mothers (in case of divorce) shall suckle their children for two whole years, if the father desires to complete the term. In the case, he shall bear the cost of their food and clothing on equitable terms. But none shall be burdened with more than he or she can bear; neither the mother should be pressed unjustly (to accept unfair terms just because she is the mother, not should the father be burdened just he is the father. And the same responsibility for the maintenance of the mother devolves upon the father of the child and his heir. there is no harm if they wean the child by mutual consent and consultation. Moreover, there is no harm if you choose to give your children to be suckled by nurse, provided that you pay her fairly. Fear Allah and know it well that whatever you do is in the sight of *Allah."*

The issue referred to in this verse of the Holy *Qur'an* is simple and straightforward. The purpose is to engage the divorced mother to feed the baby on reasonable and fair terms to both. The word used is *ma'ruf* which means well-known, universally accepted, or generally recognised; that which is good, beneficial and equitable. Thus, the Holy *Qur.'an* commands the parties in the contract of weaning to settle the cost in a well-known, equitable and generally acceptable and recognised manner to both the mother and father so that neither of them is harmed or over-burdened.

The wording of the principle stated applies equally to the father and the mother in order to safeguard their interest.Each must fulfil his or her part in the fostering of the child. And the child shall not be used as an excuse for driving a hard bargain on either side. And if they do desire, by mutual consent, they can agree to some course that is reasonable and equitable both as regards the period before weaning and the engagement of a wet nurse.

There is no such thing as an element of probability or risk liability in this case as in insurance. Both the parties in the contract of weaning are advised to settle the cost on reasonable and equitable terms, without placing undue burden on either of them. Therefore, there is absolutely no resemblance between this contract and the insurance contract.

4. Case of *Muzarea or Musakat*

A contract of *muzarea* is not free from the element of *Garar* but is allowed by *Shariah.* A contract of *muzarea* may be defined as a contract between two persons, one being a proprietor of land, and the other the cultivator, by which it is agreed that whatever is produced from the land shall belong to both in such proportions as may be therein determined." (9)

The contract is valid because the Holy Prophet allowed this form of contract and "himself entered into such a contract with the people of Khaibar, by which it was agreed that they should manage the gardens and lands of Khaibar, and enjoy one half of the fruit and grain provided from them, and that they should give the other half to him." And the same principle applies to *Musakat* (a contract of gardening), by which it is agreed that one shall deliver over to the other his fruit trees (i.e. garden) on condition that the other shall take care of them, and that whatever is produced shall belong to them both and be shared between them on the agreed terms, i.e. in the proportions of one half, one third or as may be stipulated. (9)

It is a clear cut agreement between the parties with regard to the division of the produce between them. There is no probability either with regard to the share of the parties or to the time of cultivation. Therefore, there is nothing common between *muzarea (or musakat)* and commercial insurance.

5. Wages of a Servant

A personal servant is paid a specified salary or wage in return for unspecified work. It is perfectly valid while insurance is considered invalid.

The line of argument in supporting the legality of personal servants is almost the same as for night guards discussed earlier. It is an ordinary contract between two individuals, with precise terms of payment by the one to the other in return for specific services by the latter, unlike insurance contract.

What people fail to understand is the emphasis laid in these verses upon the believers to fulfil their promises and obligations to other people. It refers to an ordinary and straightforward promise or contract made by one person and the

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9. *Hedaya,* op. cit., pp. 579-84.

other. It may be a simple promise to do or give something to another person involving moral obligations with the hope of winning the pleasure of *Allah*, or it may be a business contract between two parties including monetary obligations and liabilities on either of the parties. *Allah* reminds the believers to fulfil all such obligations and promises.

Commercial insurance contract is not a promise or contract in that sense. At least it was not meant to be a promise or obligation in the simple sense mentioned in the Holy *Qur'an*. Firstly, because here an individual insuree is seeking guarantee against future losses or liabilities from a third party and is not thinking of the 'promise' referred to in the *Qur'an*. Secondly, if it is considered merely as a promise or contract between the two parties, the insurance company has neither the ability, power or even the intention to fulfil such a promise of contract. It can be in such a position only if it enters into similar contracts with thousands of other insurees. On an individual level it can never be considered as a genuine promise or contract. Therefore, it is not true to say that the basis of an insurance contract is a binding promise.

Furthermore, though people have complete freedom to make promises or enter into all forms of commercial and non-commercial contracts, they cannot make such promises or contracts which are forbidden by *Shariah* because the very basis of such a contract (or promise) is invalid. If any believer does make such an invalid promise (or contract) to another person, he is commanded to withdraw his invalid promise (or contract) and pay damage in the form of penance or atonement (i.e. *kaffara)* for that mistake. In this matter, even the Holy Prophet was asked to withdraw his promise: "O Prophet do you forbid that which Allah has made lawful for you, seeking to please your wives. And Allah is Forgiving and Merciful (66:1)".

This verse clearly points out to the believers that if their vows (or promises) are against *Shariah,* they are told not to fulfil such promises.

At the time of the Holy Prophet, various forms of commercial and non-commercial dealings, such as a contract, monopoly, mortgage, gift, etc, involved a kind of promise. All such dealings were thoroughly examined from the humanitarian viewpoint as well as the common good of society by Allah's

Messenger, and those found against the *Shariah* were declared unlawful and others were retained in the Islamic system.

6. Pension

It is argued that element of *Garar (or Juhala)* exists in all pension schemes. A man may pay monthly contributions in pension schemes but may die and never draw a penny in pension, live for a few years and draw only a small amount, or may live for a long time after retirement and draw more money in pension than his contributions. In fact, it is not true for there is no *Garar (or Juhala)* of the kind found in commercial insurance. The pensioner will certainly draw his pension after retirement if he survives, or in the case of his death, his dependents will benefit from his pension.

The question of the pensioner drawing more than his contributions is a statistical problem and can be considered in terms of income and payments. If a man has contributed say,for forty or fifty years and his money has been invested in profitable enterprises, it must have yielded huge funds, especially if it has accummulated over a period of years. Undoubtedly, his contributions must have grown in profits into a much greater amount than he could possibly draw in a pension even if he were to survive for fifty to sixty years after retiring at the age of 65. In actual fact, the great majority of the people do not live so long and the net accummulated profits from their pension fund would be far greater than the pension they are expected to draw in their normal span of life after the age of retirement.

Moreover, it is not an indemnity contract but a guarantee to provide a pension to the pensioner or in case of his death, to his dependents, based on the gross amount of his salary in the last twelve or twentyfour months of his service at the time of retirement and the total number of years of his service.This guarantees a specific amount of money and is free from any element of *Garar (or Juhala).*

It may here be pointed out that most of the Government pension schemes are non-contributory and therefore, do not involve any of these problems. However, in a Muslim state, all pensions will be non-contributory for it is a

other. It may be a simple promise to do or give something to another person involving moral obligations with the hope of winning the pleasure of *Allah*, or it may be a business contract between two parties including monetary obligations and liabilities on either of the parties. *Allah* reminds the believers to fulfil all such obligations and promises.

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At the time of the Holy Prophet, various forms of commercial and non-commercial dealings, such as a contract, monopoly, mortgage, gift, etc, involved a kind of promise. All such dealings were thoroughly examined from the humanitarian viewpoint as well as the common good of society by Allah's

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The question of the pensioner drawing more than his contributions is a statistical problem and can be considered in terms of income and payments. If a man has contributed say,for forty or fifty years and his money has been invested in profitable enterprises, it must have yielded huge funds, especially if it has accummulated over a period of years. Undoubtedly, his contributions must have grown in profits into a much greater amount than he could possibly draw in a pension even if he were to survive for fifty to sixty years after retiring at the age of 65. In actual fact, the great majority of the people do not live so long and the net accummulated profits from their pension fund would be far greater than the pension they are expected to draw in their normal span of life after the age of retirement.

Moreover, it is not an indemnity contract but a guarantee to provide a pension to the pensioner or in case of his death, to his dependents, based on the gross amount of his salary in the last twelve or twentyfour months of his service at the time of retirement and the total number of years of his service.This guarantees a specific amount of money and is free from any element of *Garar (or Juhala)*.

It may here be pointed out that most of the Government pension schemes are non-contributory and therefore, do not involve any of these problems. However, in a Muslim state, all pensions will be non-contributory for it is a

duty of a Muslim state to guarantee social security to all its citizens, especially when they are at risk, unemployed and old. And if there are any defects in the existing pension schemes they will be rectified in such a way as to make them free from all unlawful elements of this nature.

7. Fee for *Hamam* or watering agricultural land, etc.

It is claimed that charging a fee for a bath in a *hamam*, or watering agricultural land at a price and many other such forms of business dealings contain an element of *garar* (or *juhala*) but are quite valid in *Shariah*.

As has been explained before in the case of nightguards, in all such forms of dealings, a fixed wage or compensation is paid to the labourers in exchange for their services for doing a particular job. There is neither any doubt nor any uncertainty with regard to these matters and both parties are fully aware of their specific obligations and liabilities in this contract. There is no hazard or probability as is found in the contract of insurance.

There is no comparison between such dealings and commercial insurance. Such futile efforts are made by the 'supporters' merely to confuse the whole issue of *Garar (or Juhala)* in the contract of insurance for the student of economics. They want to show that some element of *Garar (or Juhala)* is present in almost every business transaction, but this does not make it invalid and commercial insurance is no exception. In fact, this is far from the truth.

8. Blood Money for the Bereaved

It is pointed out that Islam stipulates indemnity in crime in the form of blood-money in compensation for the loss of human life to the family if a member is killed and it is no different from the indemnity paid to the insuree in case of loss or peril. Why is the former valid and the latter invalid?

This comparison is inappropriate and irrelevant. There is no option in the former for the crime is committed by someone having no previous contract with the survivors of the deseased.He is punished for his crime in the form of financial penalty to be paid to the family of the killed. This is a punishment to the criminal as well as assistance to the survivors.

In commercial insurance there is a deliberate contract to provide compensation prior to the happening of a peril to the insuree. In commercial insurance compensation is paid to the insuree in return for premiums on the happening of an event. If premiums are not paid, or discontinued, no compensation is paid. Thus, in commercial insurance, payment of premiums and indemnity are inter-related; whereas in crime there is no such relationship.

Blood-money is a form of deterrant as well as a punishment which is given when the crime has actually occured. At the same time, it provides help to the bereaved person or persons. Thus, the very nature of indemnity in crime is entirely different from that of commercial insurance and it does not contain the element of *Garar (or Juhala)* found in the latter. Therefore, the comparison between indemnity in crime and indemnity in commercial insurance is not valid.

9. *Mudarabah* and Insurance

It is claimed that commercial insurance is a perfectly valid form of business from which both the parties benefit, i.e. the insurance company and the insuree. The former contributes its labour and enterprising skill, etc., and the latter, its capital and both gain from the business, commonly known as *Mudarabah (or Qisadh)*.

It is difficult to understand how and in what manner it could be considered a contract of *Mudarabah*. The attempt to compare insurance contract with *Mudarabah* is not only unwarranted but is also outrageous. The very nature of an insurance contract is basically different from that of the contract of *Mudarabah*. The 'supporters' are trying to confuse the issue by dragging this valid form of business into line with insurance business. There is no shred of evidence either in the nature or in the terms or conditions of the insurance contract, which shows that it is like the contract of *Mudarabah*.

There is no participation in profits by the insurees in insurance which is an essential condition of the contract *of Mudarabah.* There is no intention of profit-sharing in insurance. It is never the intention of either the insurer to give the profits, or of the insuree to receive profits as such from the former.

It is also not true that the insuree is providing capital to the insurance company so that both may share in the profits and that the latter is like a working partner in the contract of *Mudarabah.* The idea that the insurance company is a working party with the insuree is absolutely false because there is no such thing. In the contract of *Mudarabah,* capital belongs to the sleeping partner and profit is shared between him and his working partner on agreed terms. In the commercial insurance the division has no resemblance whatsoever to the contract of *Mudarabah.*

It seems absolutely ridiculous to compare the insurance contract with the contract of *Mudarabah* and then draw conclusions quite contrary to the Law of *Shariah* in support of certain pre-conceived ideas. If *Mudarabah* is the basis of insurance contract, then who are the partners in this contract? And who is the *Darib* and who is the *Mudarib,* and how? Do they share profit? If the answer is 'yes', what is the share of the insuree in the profits and how and when does he get it?

13

COMMERCIAL INSURANCE ON CO-OPERATIVE BASIS

It is argued that commercial insurance is based on the principle of mutuality and co-operation and there is nothing wrong in it. The main arguments of the 'supporters' are summarised below:

(i) Commercial insurance is primarily based on the totality of the insurees who are faced with common danger. The basis of co-operation between the insurees is the common danger threatening all of them. It is a natural instinct of man to avoid risk as far as possible. All the insurees who are likely to face this common danger co-operate with each other to avoid such risk or loss. If such a peril occurs, they alleviate loss by shouldering this burden together. Commercial insurance is organised to eliminate the probable danger to the person or property of the insurees.

Thus, co-operation exists in commercial insurance but in a different way. It is not based on prior consultation as in some forms of insurance (i.e. in mutual and co-operative) but through the efforts of an intermediary (i.e. the company) who achieves this objective by gathering large number of insurees facing a common peril. The second party (i.e. the insurance company) who manage to bring all the insurees together also make money out of this business, which is natural , and, as such, does not in any way jeopardise the principle of mutuality and co-operation.

Some people do not take account of the element of mutuality and co-operation in commercial insurance and consider it a profit-based business like any other. In fact, commercial insurance is different from other types of business because of its basic function which is to eliminate or reduce the element of risk by distributing it among a large number of people. The loss is reduced to smaller units which are borne by all insurees in the form of premiums. They all help each other through the offices of the commercial insurance company.

The whole line of argument is based on wrong, flimsy and fictitous grounds. Co-operation in commercial insurance is fake and not real. There are absolutely no grounds to compare commercial insurance with co-operative or mutual insurance or to call the former co-operative insurance.

It is assumed that commercial insurance is organised for the welfare of the insurees and on the principle of co-operation. Both the premises on which the case for commercial insurance is built are non-existent and unreal. The fact is that modern commercial insurance is totally commercial and is organised for the purpose of profit-making from the lives, deaths or dangers of other people. Some eminent scholars have called life insurance as a ' business of making money out of people's death.' There is no element of co-operation , mutuality or solidarity of the insurees in commercial insurance.

Besides, it is neither in the constitution of the insurance company nor in its insurance contract with each individual insuree that it is organised on the principle of co-operation. The shareholders who are the owners and controllers of the insurance company have no intention to claim any element of mutuality or co-operation for it. The profits of the company are distributed among the shareholders and not among the insurees and there is no intention of the shareholders or the company to give any share of the profits to the insurees.

Moreover, the insurees, who are scattered all over the country, have neither the knowledge of such co-operation nor do they have any contact with each other.They even do not know each other nor do they ever come together. Each insuree seeks his protection from the company as an individual without even knowing anything of the co-operation with other insurees. So where is the co-operative or mutuality element in commercial insurance? How and what manner do the insurees actually participate and mutually co-operate with each other in the process or act of insurance?

Various examples offered to prove the existence of co-operation and mutuality in commercial insurance are totally irrelevant and absurd. It shows that the 'supporters' of commercial insurance are either completely ignorant both of the principles of economics and of the code of Shariah, or they are covertly hostile to the Islamic discipline. In the first case, it would be desirable or

appropriate for them to acquire necessary knowledge before they pass judment on the validity or invalidity of commercial insurance, and in the second case, they are socialists disguised as 'Muslims' who lack the courage to oppose Islamic principles in the open and have therefore adopted under-cover methods to legalise and validate unlawful systems for the Islamic society.

The case of those innocent Muslims who are ignorant of the basic principles of Islam and the wisdom of Shariah and are trying to justify commercial insurance by mixing it with co-operative or mutual insurance, is different and understandable. In fact, insurance business in its very early stages was organised on the principle of mutuality and co-operation. The Greek burial societies, Roman burial clubs and the Arab custom of blood-money in general, and Muslim mercantile mutual and co-operative societies in particular, are the notable examples in the early history of insurance, while the establishment of "Friendly societies" in England and other European countries around the dawn of the modern insurance business could be called the fore-runners of this type of business organisation.

It was originally based on mutuality and co-operation and some people wrongly continued to describe even commercial insurance as mutual and co-operative insurance. The mutuality theory has taken stock of the fact that in its early stages insurance was organised to a great extent on a mutual and semi-public basis. This theory emphasises the social value of insurance and defines it 'as a brotherhood of men who unite against the all-destroying effects of the unfettered forces of nature.' They thought that the great advantage of insurance lay in the fact that when applied in its mutual and most common way, it considerably alleviates the misery of mankind."(1) The gratification of human needs and wants can to a great extent be fostered by insurance which they describe as ' a kind of hedging against extreme misfortune by an agreement between certain number of persons, namely those who take policies in the office, that those who are fortunate shall support those who are unfortunate."(2)

But commercial insurance as practised today has no relevance to the principle

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1. Barou, N., ***Co-operative Insurance,*** op. cit., p.28
2. MacMillian, ***The Promotion of General Happiness,*** London, 1890, p.161

of mutuality or co-operation and there are absolutely no grounds to treat them as one and the same thing. This is because:

(i) The former is organised on the basis of profit, whereas the latter is based on mutuality and co-operation.

(ii) The former is owned, controlled and managed by the shareholders who are rarely the policy-holders of the same company whereas the latter is controlled and managed by the policy-holders themselves.

(iii) The former is organised by the shareholders of the insurance company to make profit, while the latter is organised by the policy-holders with the object of mutual help and co-operation of its members.

(iv) The former works under the direction of the shareholders, while the latter works with the co-operation and by the help of the members themselves.

(v) The former distributes its profits among the shareholders, while the latter distributes profits, if there are any, among its policy-holders.

(vi) The former operates in the interest and for the welfare of its shareholders, while the latter operates for the interest and welfare of its members who are the policy-holders .

(vii) All the funds of the former belong to the shareholders, while in the latter they belong to the policy-holders.

This makes it absolutely clear that no element of mutuality or co-operation is present in commercial insurance from its formation to the last organisational and functional stage. At no stage in the working of modern insurance companies is there any demonstration of co-operation.

Co-operative insurance and mutual insurance are quite different from commercial insurance in rescpect to their nature, management, control, organisation, functions and even in the distribution of profits. Both forms of insurance are based on different principles even though both are founded on a contractual basis and it would be a mistake to treat them as one and the same thing. This view is fully supported by Barou in the following words,"Certain types of insurance, e.g. underwriting, which have nothing of a collective nature because the combination and offsetting of risks by the underwriters concern only the insurer and not the insured. Besides, the mutuality is not identical with a certain form of mutual and co-operative efforts or with a conscious participation of the insured in a risk community institution.

- How can all forms of insurance be mutual when the mutual character is actually unknown to the insurer and insured? What is the value of an economic inter-dependence between the insured and insurer of which neither of them is aware? Ony where it becomes a conscious expression of organised co-operation and mutual effort, only when it is expressed in a new form of social organisation, only then can mutuality become a real force in insurance and in other spheres of human economic activities."(3)

The mere regulation by laws of the state concerning the organisation, investments and profits of the commercial insurance companies does not change the nature of the commercial institution as such.

3. Barou, N., ***Co-operative Insurance***, op. cit., p.41–2

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14

GENERAL REVIEW OF COMMERCIAL INSURANCE BUSINESS

Now we will analyse some aspects of commercial insurance with particular emphasis on (1) the insurance contract; and (2) life insurance in general.

(1) Insurance Contract

(a) The whole basis of modern commercial insurance is the theory of large numbers. When many people co-operate in a business venture where risk is involved, the risk becomes more determine. The risk element is calculated and each individual insuree pays a determinate amount of insurance premiums by instalments.

" Insurance relies heavily upon the 'law of large numbers'. In large homogenuous populations it is possible to estimate the normal frequency of common events such as deaths and accidents. Losses can be predicted with reasonable accuracy, and this accuracy increases, as the size of the group expands. From the theoretical standpoint it is possible to eliminate all pure risk if an infinitely large group is selected."(1)

The principle of large numbers is further explained by Waite and Davenport in these words: " When the probability of an event is negligible or small, the degree of uncertainty is also negligible or small, but, " after the point of even chance has been passed, probablity increases, as the uncertainty increases, i.e. uncertainty is at a maximum when probability is ½ and it decreases in both directions from the point as probability increases to one or decreases to zero.

The increase in the number of occurrences results in greater regularity of their

1. *Encyclopaedia Britannica,* Vol. 9, 1973, p.645

happenings, and the probability of many phenamena becomes readily predictable in groups of sufficient size; and risk, when taken in very great numbers, mostly merge into the uncertainty of the general average. The increase of the number of cases thus has a direct effect on the area of uncertainty which is more easily calculated and estimated in large gruop."(2)

" It becomes less for a large group than it is for any of the members of the group. One man may or may not die, one house may or may not burn, but a thousand men or a thousand houses behave in a predictable way."(3) The same is true with regard to trade risks. What is of importance for an enterprise is not the risk of a failure in any of its particular contracts or operations," but the chance of a considerable divergence from the most probable number of successes over the whole output." (4) With the increase of the number of operations, the chance of such divergence diminishes. In insurance, " regularity of the aggregate is invoked to correct the 'single instance', this can be achieved in different ways and the exponents of the risk theory have spared no efforts to find them."

It is argued that the rate of danger becomes steady in case of large numbers and can be predicted and predetermined through statistical study and experience over a period of time. The theory of probability, based on statistics, plays a great part in commercial insurance. The problems like (a) the expected age of the insuree and (b), the expected number of accidents, can be solved and predicted through mathematical formula. As a result, the element of uncertainty and chance can be reduced to a negligible degree.

The law, in fact, is related to a practical probability of life and insurance companies have benefitted from it. Insurance premium is a ratio of the amount an insurance company takes into consideration while issuing a

2. Waite, *Economics of Consumption,* p.174 and 404–5, Davenport, *The Economics of Enterprise* quoted by Barou., op., cit., p.14–15
3. Clark, *Studies in Economics of Overhead Costs,* p.126, quoted by Barou, op., cit., p.126
4. Hicks, *The Theory of Uncertainty of Profits, Economics,* 1931, p.185, quoted by Barou, op., cit., p.126

particular insurance policy against certain danger. The whole business is based on two propositions,(i) past tables and averages, and (ii) laws of the majority against the minority of few. Take, for instance, fire insurance. There are far more people insured against fire hazard than those whose properties are actually burnt. Income coming in from various insured properties is always far greater than the outgoing amount paid to those whose properties are destroyed. The expertise of the insurance companies compare their past records and the table of premium claims and prepare very accurate estimates for the current year which do not warrant any element of uncertainty or chance, *garar* (or *juhala*).

The insurance company pays claims, the salary of staff and other overhead charges and also saves funds for essential calamities as a Reserve Fund. The terms, conditions, premium monies and amounts of claims, etc., are all specified and spelled out clearly in the contract of insurance. There is thererfore, very little which is left to chance or uncertainty *garar* (or *juhala*).

But the facts belie these claims because the theory of large numbers does not in any way change the nature of probability. It may to some extent reduce the intensity of probability for the insurer in certain cases but cannot substantially affect the dimensions of the risk probability or change the nature of probability for the insuree. The existence of statistical tables, past records, knowledge and experience of the expertise may help in forecasting better and accurate probable occurrences of peril in general but cannot accurately forecast either the amount of total eventual claims against total losses or claims of the individual insurees.

Moreover, there is an individual contract with each individual insuree by the insurance company and there is no such thing as a contract with a group of insurees. And there is definitely an element of probability and uncertainty, *garar* (or *Juhala*) , in each individual insuree's contract. The number of insurees may affect the degree of probability to some extent from the point of view of the insurer but it does not affect or change the nature of risk probability for each individual insuree. This is the basis of the whole insurance business.

In fact, large numbers help the commercial insurance companies to make huge

profits from their insurance business but do not provide any practicl relief in any form to the insurees. The element of probability and uncertainty still remain as indeterminate as ever for each insuree.

(b) It is said that the insurance contract is not a contract of probability because the existence of large numbers of insurees have brought certainty for the sufferers of any peril. Each insuree wants to avoid risk so he co-operates with other insurees who face common danger. It may be probability for one insuree but not for the total of all insurees. In this form of insurance the insurees face a common danger through a common intermediary unlike mutual insurance. The role of the insurance company is that of the agent who organises their co-operation. As such, rights and obligations of the contract fall on both the parties (i.e. the insurance company and the insurees). So long as the parties respect and honour their obligations to each other, the insurance contract works very well for the benefit of all.

Again, the whole case in support of commercial insurance is built on wrong assumptions. It is assumed that the insurance company is established for the welfare of the insuree and is organised on the principle of co-operation. The insurees co-operate to safeguard their interest against future peril or hazards. But both the premises on which the case for commercial insurance is built are unreal and imaginary. The fact is that the insurance company is established only for profit-making. There is nothing in the laws of the company, its constitution, or in the insurance contract that may, directly or indirectly, suggest that it is formed for the welfare of the insurees. There is neither co-operation among the insurees themselves who are scattered all over the country and totally unaware of this, nor any welfare motive on the part of the insurance company. The two elements of co-operation and welfare are in fact conspicuous by their absence from the field of commercial insurance.

(c) It is claimed that insurance contract is an indemnity contract because it gives compensation to the injured party, but in fact, it is not so. The insurance company enters into an agreement with an individual insuree and, technically, it is not possible for it to pay compensation if there was only one insuree. it has to make similar contracts with large number of insurees in order to be able to pay off debt to those who have suffered a calamity. Apparently, the insurance company is sympathetic to one party while engaging in similar

gestures with a large number of insurees at the same time. Each insuree, out of a large group of people facing danger, is promised similar compensation on the happening of an accident or a peril.

It is quite obvious that the insurance company can neither pay compensation to all nor intends to do so. What it is interested in is to profit out of the weakness of individual insurees. In fact, an insurance contract is applicable to the insurees as a group and not to each individual insuree. As such, it is a false contract partly because the original insurance contract was made with each individual insuree and not with the insurees as a group, and partly because the insurees as a group never come together at any time for this purpose. There is no such thing as a deliberate coming together of all insurees facing common danger and joining together either through an express agreement amongst themselves or through the good offices of the insurance company.

(d) It is alleged that an insurance contract is like any other business contract and has all the ingredients of a valid contract. (i) The contract is reciprocal in the sense that the insurer will pay indemnity or compensation if the insuree keeps his part of the contract, i.e. to pay all the premiums agreed to in the contract.(ii) The contract is binding on both the parties in the sense that when the insuree has paid all the instalments of the premium, the insurer must pay against loss if and when it occurs.(iii) The contract is often well-publicised contract. The terms are defined, printed and form part of the contract.(iv) It is not an indefinite contract because it is always dated from one specified date to another.

In fact, it is not like an odinary business contract because if the peril does not occur, the insuree gets nothing, whereas in an ordinary business contract, there is exchange of goods, money or other consideration between the parties. The insurance contract is therefore neither like a normal business nor is it reciprocal or binding. In the case of non-occurrence of a peril, reciprocity or compulsion on the part of the insurer is non-existent. Where is the indemnity in all such cases? It is therefore, a matter of chance that an insuree may or may not receive indemnity and he cannot be sure that he would actually receive it.

Indemnity is promised for a probable loss in future in return for payment in

the present. Thus, guarantee of payment depends on the occurrence of a peril; in other words, realisation of indemnity depends on outside factors that are unknown and uncertain. Besides, payment of indemnity (i.e. debt) is guaranteed by a third party. As the occurrence of a peril, which is the basis of the contract of indemnity, is uncertain, publicity of the contract or its well-defined conditions and timed dates become irrelevant. Uncertainty of peril renders these meaningless and ineffective.

It may be pointed out that a business contract (involving exchange of goods, values, money or other considerations) must be related to reality and not imagination. Intention of the participants in the contract and consideration of the terms of the contract are very important. In fact, these two factors determine the validity of a contract. It differentiates between the compensation and indemnity and demands that a contract must be based on the exact terms, conditions and the intention stated therein. This relationship between the parties and the intention , and rights and obligations of each party are basic requirements that must be clearly stated in the terms and conditions of the contract. This relationship between the parties determines the validity of the contract.

If judgment is given on the basis of reality and not mere conception an insurance contract seems invalid on the following grounds:

(i) It is required to be a contract of indemnity, but in actual fact, the amount of compensation is rarely equal to the amount of premium money, especially in accidents and life assurance.

(ii) In some forms of insurance, the amount to be insured is not defined or determined, for instance, in car insurance, no maximum amount is stipulated.

(iii) No compensation is paid in case of the non-occurrence of a peril and also no indemnity is forthcoming.

(iv) Insurance is usually greater than the amount paid in premium.

(v) An insurance policy is forfeited if premiums are not paid but the premium money is rarely paid back in full to the insuree.

An insuree in all such cases has little chance of receiving any part of his premium money, not to mention full payment. He will be lucky if he gets some portion of his premium money from the insurance company.

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An insuree in all such cases has little chance of receiving any part of his premium money, not to mention full payment. He will be lucky if he gets some portion of his premium money from the insurance company.

If the termination of an insurance policy by the insurance company or by the insuree, comes after a couple of years, then the insuree receives almost nothing. The history of British insurance bears witness to the fact that the public is completely robbed of their money by the insurance company in all such cases.

(vi) A contract must be signed between the parties without any intermediary or agent. If it has to be signed through an agent, the parties must have complete freedom of selection of their agent or intermediary who would act on their behalf. Besides this , no agent appointed by the parties can ever work against the interests of his own employer.

The insurance contract fulfills none of these essential requirements of the contract. The relationship between the parties is neither on equal terms nor on reciprocal basis. Their rights and obligations , especially of the insuree, are more or less dependent on unknown factors. In addition, the insuree has no choice in the selection of his agent. He has to insure with an insurance company on its own terms and conditions. The insurance company either assumes the role of agent on behalf of its insurees or appoints its agents for this purpose without any reference to or consultation with its insurees who are merely its clients during the terms of the insurance policy.

The insurance company has made the contract for consideration of profit for its shareholders and not for the welfare or benefit of its insurees. Its main purpose is to make profit and the interest of its insurees never comes into consideration. If there is any gain to the insurees it is just a bye-product of the business. This is because the whole structure of the commercial insurance business is based on profit.

As the interest of the insurance company is to make as much profit as it can out of the weaknesses of the people, it cannot be expected always to work for the benefit of its insurees. In other words, its interest is totally opposed to that of the insurees, and therefore, it cannot be expected to act as a genuine agent of the insurees. Moreover, it is never treated as such in the insurance contract or in the constitution of the company. It is formed to make profit out of insurance business and not to act as a welfare society for the people.

This brief discussion clearly shows that there are many flaws in an insurance contract with regard to risk, premiums, indemnity, law of probability and statistics which have not been rationally and scientifically explained to clarify doubts about the nature and purpose of commercial insurance.

Thus in judging insurance as it actually is and not merely as a conception, no other conclusion can be drawn except that it is an unlawful institution.

2. Life Insurance

(a) Life insurance does not deny that death will not occur, nor does it guarantee the insured that he will live for many years. What it does is to make sure that the losses of the people affected by the calamity of death are partially or fully covered. It promises to pay a certain determinate amount to the family of the deceased if he died before a certain date, i.e., before the contract matured. In other words, it covers the risk of death to a certain date.

(b) People take out life insurance for various reasons but the majority of the insurees seek life insurance partly because they get assurance that in case of their death their families will get a reasonable amount of money to meet their economic needs. Thus, the main purpose is to safeguard the future of their families and to insure against death before a certain date.. In other words, it is a scheme which enables the insurees or their dependents to receive accummulated funds including profits at the maturity of the insurance contract.

(c) Both the parties enter into the insurance contract knowing fully the probable consequences, charges and other terms or the conditions. There is nothing which is left hidden from them.

(d) There is a risk element but mathematical calculations and multiplicity of numbers have reduced it almost to a calculabe risk and not a probability. Insurance renders individual risk into a collective one. A small amount of loss of an individual insuree is spread over a large number of people and thereby the risk is minimised or reduced.

The study of life insurance shows that many delicate and complex questions remain unanswered.

(a) How can life insurance safeguard against death? Death is not a probability but certainty. How can you insure against an event which is certain? The whole basis of life insurance is the presence of an element of risk which is likely to occur. It may or may not occur. The risk probability of death before a certain date remains uncertain, it may or may not occur, but death risk, in general, is certain and is not a probability. It becomes a probability only within relation to the time or date fixed by insurance companies for the maturity of the insurance policy. Therefore, technically speaking, the subject-matter does not fall within the scope of "insurable interest" because it is not a probability but certainty.

(b) Even if we admit that it is within the scope of insurable interest, we face the difficulty of assessing the value of life or future loss of life. How can this loss of life be calculated in money terms? It is a very complex problem and there is no easy or ready-made answer to it.

(c) The problem of saving is another anomally in life insurance. There is neither any mention of saving in the insurance contract nor is this the intention of either of the parties (i.e., the insurer or the insuree) that the premiums are paid for the purpose of saving. Neither of the parties had intended at the time of insurance contract that the funds were to be in the nature of saving by the insuree with the insurance company, and that the latter would pay compensation to the former out of accummulated profits of its savings. It is neither in the insurance contract nor in the rules of the insurance company that it would return accummulated saving to the insurees in the form of compensation at the end of the insurance contract. This is all an after thought and a fabrication of the minds of the 'supporters' of the life insurance.

(d) In case insuree dies after paying the very first instalment, his family or dependent will collect a lump sum. If, for instance, the compensation agreed was £10,000 and each yearly instalment was of £200 -, the family or dependents of the deceased will collect £10,000 in return for the payment of £200. The question arises in return to what do they collect the lump sum of £ 10,000 ? If he had survived, he would have himself collected £ 10,000 at the end of the contract. Is there any relationship between what is paid and what is collected? There is an element of *riba* (interest) in both cases, whether the amount is collected by the insuree himself or in case of his death by his family or dependents.

(e) Life insurance is not a contract of indemnity. Besides, how can one determine the value of one's life in terms of compensation or fix the premiums to be paid by the insuree? When we cannot measure life value in monetary terms, how can we fix a monetary value of the deceased father of the orphan or of the deceased husband of a widow? One may provide some of the economic needs of the family, but one cannot compensate them for the loss of the father or the husband. In all such cases, the value is indeterminate, it cannot be scientifically and accurately determined in money terms. All the arguments of the 'supporters' fail to give any reasonable basis for determining accurately the amount of compensation or premium in the case of life insurance.

(f) There are many flaws in linking the law of probability and statistics in life insurance.

(i) The theory of probability is based on the statistics of averages and plays an important part in insurance. The insurance companies take into consideration firstly, the expected age of the insuree, and, secondly, the distribution of the probable danger, in this case death. They check birth and death tables and in this manner can determine the life-span of various insurees through a life number based on large numbers, which, in turn, affects the insurance premium to be paid by each insuree. The larger the number of insurees the more constant the life-span will be.

(ii) This law is related to the practical probability of life but the insurance companies do not know the life-span. However, they have greatly profitted from the law of large numbers. The insurance premium is generally determined by the total number of insurees, the larger the number of insurees, the lesser the amount of premiums.

Thus, in fact, a net premium is determined by the same formula as in gambling or betting. This is the actual value of occurrence of the peril. And there is no fundamental difference in the various forms of gambling as far as the element of uncertainty or wagering is concerned.

(iii) In life insurance, the profits are huge and are retained by the insurance companies. Every effort is made to increase the profit and in this race to make more and more profit, the very object of insurance is lost. The 'supporters' of life insurance (and commercial insurance in general) argue that the means are justified for achieving better ends (i.e., security) through insurance. But now it is quite clear the reverse as means have taken over the ends. Now the main aim of life insurance companies is to get higher and higher profit to which there is no upper limit. And as profit rises, the premium becomes higher and higher.

(g) Above all, interest is a part and parcel of the whole process of accumulated savings which are alleged to be returned to the insuree or his dependents at the end of the insurance contract , as explained earlier in this book.

15

CASE FOR INSURANCE

An insurance contract is a new contract and was not in existence during the time of the Holy Prophet and there is no mention of this type of contract in the *Qur'an* and *Sunnah* of the Holy Prophet. As there is no clear verdict from the *Shariah* about this form of business, it is perfectly lawful because it is useful and beneficial for the people and the Holy Messenger has said,"lawful (*halal*) is what Allah has allowed and unlawful (***haram***) is what Allah has forbidden." When Allah and His Messenger have said nothing about commercial insurance, it must be valid and lawful. It means that all contracts and things are lawful unless there is explicit restriction or prohibition and when there is no such restriction or prohibition in the *Qur'an* and *Sunnah*, it is lawful.

The opinions of jurists are based on interpretations and are not , therefore, binding; besides, they all differ on details of matters like commercial insurance and provide no clear and unanimous verdict. In fact, insurance business is not against any clear law of ***Shariah*** in any way. According to the principle that if a thing does no harm to anyone it can be accepted without infringing any principle of ***hariah*** as the Holy Prophet has said," Do not harm and no harm will be done to you."

Besides insurance is a useful institution, both for the individual and the community, we must therefore work together to make it a success as the *Qur'an* says," Co-operate with all in what is good and pious."(1) And these principles are unanimously accepted by the jurists. We can bring ***Shariah*** interpretation in support of commercial insurance as a lawful business which provides guarantee against future uncertain debt or loss. There are many lawful practices which contain an element of ***garar*** (or ***juhala***), but are allowed by *Shariah*. For example, surety or guarantee ***(kafalah)***, mutual assistance or

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1. *Qur'an*, 5:2

friendship (*mawalah*), deposits (*wada'a*), mortgage (*rahn*), agency, contract of wages or prize, bloodwite etc. If all these and many other contracts of the same kind having a considerable degree of *garar* (or *juhala*) are lawful, commercial insurance must also be considered as lawful.

This shows that commercial insurance is just like so many other business contracts of our time. The contract is binding on both parties and is reciprocal in the sense that insurance is dependent upon the payment of premiums. The contract itself has a risk element and liabilities of the parties are unknown and uncertain but the terms and conditions of the contract are well-defined and well-publicised. There is no vagueness as to the nature of the risk or the extent of the liabilities of the parties. Both the parties are fully aware of the risk involved and of their obligations, though they are not specified. Furthermore, the contract is not an indefinite one but is always dated from one date to another.

In addition, commercial insurance has many benefits, some of which are given below:

(a) Man is driven by self-interest to avoid danger, therefore, he tries his best to seek guarantees against any probable loss to his person, property or business. The insuree wants to insure against probable peril with the insurance company in return for some payment in the form of a premium. The insurance company promises to compensate the insuree for his loss or debt in return for a premium.

The insurance business is based on the principle of numbers. As the number of the insurees is large and the number of accidents few, the insurance company can afford to pay compensation and still make a profit. It is very easy and convenient for an individual insuree to pay a small premium by instalments and insure against probable danger or accident. In this way, by paying small instalments, he can insure continuity, stability to his business , and safety to his person or property. Thus, insurance provides safeguards against any future losses, risk or peril and meets the needs of people in distress and turns their misery into happiness, or at least minimises the extent of their misery.

(b) Commercial insurance has become very popular, common and almost an established and accepted practice with people all over the world. No society can now survive and progress without it, it must therefore be accepted and adopted in the economy as matter of necessity. There is a great need for it because it is a useful business and is almost indispensable in modern industrial society. It is approved by Hanafees, for, according to them, when any business is commonly accepted and practised by the people it becomes valid and lawful because of necessity.

(c) Social necessity demands that commercial insurance be adopted as a lawful business. The individual' s interests are threatened by multifarious hazards in the modern world and he wants to preserve his lawful interests. The best way to preserve his interests is by insurance.

(d) It builds up the national economy. Insurance companies are able to collect huge funds from the public in premiums which are invested in national, productive industries. This constant flow of funds into trade, commerce and industry helps in the growth of wealth and capital in the country. Thus, insurance savings help in building up the national economy of a country.

(e) Commercial insurance provides peace of mind and sense of security to the insurees which is a reasonable return for premiums.

(f) Commercial insurance is a modern method of business necessitated partly by public interest and need and partly by individual welfare. Thus, the motive and subject of insurance are not against but in conformity with the laws of *Shariah*. It is , in fact, a means of realising personal and social welfare.

(g) It seeks co-operation and help from other people to provide a guarantee against loss or risk to those inflicted by a calamity and this is no crime against society or *Shariah*.

It is argued that the insurance contract is a new thing and was not in existence at the time of Holy Prophet, nor is there any clear verdict about it in the *Qur'an* or *Sunnah* of the Holy Prophet. Even the Muslim jurists have not come

to any unanimous decisions with respect to the validity of insurance. Insurance business, therefore, must be legal because there is no prohibitory commandment against it.

It may be pointed out that *Shariah* has not mentioned by name all the unlawful forms of business contracts or transactions but has explicitly laid down the basic principles that determine the validity or otherwise of many forms of business. The principles have been explained and discussed above in the light of the *Qur'an* and *Sunnah*. We have to judge the validity of an insurance contract in the light of these principles. If all or any of the unlawful elements are present in the insurance contract, it will be considered an invalid form of business.

In *Shariah* there must be a valid reason and justification within the law for adopting any new contract or discipline in the Islamic relegion. This raises a number of questions:

(i) Can we enter into a contract that is not known to *Shariah?* The answer is yes, any business or commercial contract can be introduced in the economy provided it is within the laws of *Shariah* and does not contain any elements like *Garar (or Juhala)*, prohibited by the *Qur'an* and *Sunnah* of the Holy Prophet.

(ii) Can we acquire a guarantee etc., by paying some amount of money? Again the answer is 'yes' if it is subject to the same conditions as explained under (i) and provided that no unknown or vague quantities are found in deal.

(iii) Is this guarantee valid when we do not know some or all the terms and conditions of the contract? Whether the event will happen or not? What will be the nature and extent of the peril? The answer is 'no' because such a contract is openly in conflict with the express commandment contained in the *Qur'an* and *Sunnah* of the Holy Prophet, explained in previous chapters. It is pure gambling and also contains elements of *Garar (or Juhala).*

(iv) What is the legal *(Shari')* basis of insurance that can make it a lawful and valid form of business? Commercial insurance. based on principles formulated and initiated by the West and now practised almost in every country all over the world, is totally unacceptable to *Shariah*. Modern commercial insurance contains all the unlawful elements that are forbidden by Islam, e.g. interest, gambling, *garar, juhala,* etc.

If we can reorganise the whole insurance business on the basis of equality and mutuality of liabilities and obligations of the parties, as it was practised by the early Muslims and for centuries right up to the dawn of the modern era, we can bring it fully in line with the principles of *Shariah*. The most common and practical forms of this insurance will be on the principle of mutual and co-operative insurance.

(v) Is there any chance of organising insurance on the right principles while it involves elements of interest, hoarding and exploitation?

No, any business containing an element of interest *(riba)* is explicitly forbidden by the *Qur'an* and *Sunnah* and there is complete unanimity of opinion among the Muslim jurists on this point. Insurance business involving these elements is totally forbidden. Modern insurance business which contains all elements at all levels of business is unlawful and totally unacceptable to *Shariah*. Interest remains forbidden in *Shariah* whatever its quantity, small or big, and whatever its form, whether in insurance, in trade, commerce, cash or anything else. (2)

Now let us take the point of the 'supporters' one by one:

(a) There is no objection to the desires and efforts of people to avoid danger and seek guarantee against any probable peril or danger provided they do it within the law of *Shariah*. Every society had certain laws and regulations which govern the activities of the people and would under no circumstances allow to anyone to break these laws. People, therefore, adapt themselves to live within the legal system of the society.

Likewise, Islamic society has its own laws and regulations and people are expected to engage in various activities, commercial or non-commercial, whithin the scope of these laws. If people are anxious to safeguard their future interest against various sorts of hazards, they must organise lawful forms of insurance based on the principle of co-operation and mutuality instead of the evils of Western society including interest, gambling and *Garar*.

(b) The argument that if any contract gets into customary use and becomes daily accepted a routine of the people, it becomes valid, does not give a very

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2. For details see 'interest' in Vol. 111 of this book.

logical and scientific basis for the justification of insurance. The mere fact that a discipline or a form of business contract has been accepted and practised by some groups of Muslims or Muslim countries, irrespective of its validity in the *Islamic Shariah,* does not make it lawful. It will remain illegal in the eyes of *Shariah* even if all the Muslims accept and practise it.

Islamic system is not against adopting new and foreign disciplines or business contracts that are useful and necessary. What it is against is the acceptance of unlawful disciplines which are not within the scope of *Shariah* and infringe its principles. Commercial insurance is widely practised in the Western countries and is becoming popular in Muslim countries as well. But the mere fact that it is widespread is not a sufficiently strong argument for the justification of commercial insurance. If we take this argument further, we shall have to legislate for alcohol, gambling, abscenity or even adultery and homosexuality as a matter of necessity or custom because they are becoming a common habit of the people .

If we are going to accept commercial insurance as a matter of necessity and need we must prove the need for it in the Muslim economy, and show that it is necessary for the growth of industry, etc., and for the survival of our system, and, above all, that it falls within the scope of the Islamic Law.

A true and practising Muslim will always judge every new discipline or business contract on these principles and will not hesitate to recommend is adoption by the Islamic system if found really useful, necessary and within the scope of the Islamic Law.

(c) The argument that commercial insurance provides an opportunity to ordinary people to save something for a rainy day is no argument. Firstly, because it is neither the intention of the insurance company to collect premiums as 'savings' for the insurees, nor the intention of the latter to pay instalments as 'savings'. Secondly, it is neither in the constitution of the insurance company to collect 'savings' from the insurees for 'investment' purposes, nor is it in the insurance contract that the insurees are depositing their 'savings' with the company for 'investment' purposes. Thirdly, if the insurance company was really collecting 'savings' from the insurees for investment purposes, these must be paid back to them at one stage or another. But in non-occurrence of a peril, the insurees get nothing. What about their savings? Why have all their 'savings' been usurped by the insurance company? And what has the insurance company paid to the insurees in exchange for their 'savings' in this case?

As alleged, if saving is the only or main purpose of commercial insurance, then other better and more profitable as well as productive methods of 'savings' can be used to enable ordinary people to save small amounts from their low incomes. This is not the only way to collect 'savings' and help in building up the national economy. This philosophy of insurance business to build up the national economy and National Savings Fund is merely a fantasy of the 'supporters' of commercial insurance in the Muslim world.

The attitude of the 'supporters' to project commercial insurance as a profit-making institution violates not only the basic principles of pure insurance business, but also infringes the Law of Islamic *Shariah* and makes a mockery of the rules of a just and decent integrated society. It is sheer greed or mere ignorance that has prompted 'some people' to use such a good and beneficial institution as insurance to make profit.

Insurance is a form of transaction and needs legislation for its proper and efficient functioning. Western society has made its own laws to meet its needs with respect to insurance. The Muslims have to first decide whether there is really any need for insurance in a fully functioning Islamic society. Then, if it is found necessary and useful, they have to make their own laws to adjust it to their requirements within the Code of *Shariah*. Western Society has used it for commercial purposes which has led to the exploitation of the weak and to so many other evils of grave consequence. The Muslims must use it with great care and caution on the basis of equality, mutuality and co-operation for building up a healthy, prosperous and intergrated Islamic society such as that of the early Muslims.

Before analysing as to how far and to what extent commercial insurance actually helps in saving capital and building up the national economy of the country, it is appropriate to put a few questions to the 'supporters'.

(i) Do the insurees really invest their money as 'savings'? Do they pay their premiums to the insurance company like the ordinary depositors in the Savings Acount with a commercial bank?

If the answer is yes, what happens to the savings of an insuree who never suffers a calamity?

(ii) Do the commercial insurance companies really contribute to the National Savings Funds? If the answer is yes, in what way do they contribute to the savings of the nation as a whole, other than to fill the coffers of a few capitalists? And how does the poor man gain from these 'savings'?

(iii) Do they really help in building up the national economy? If the answer is yes, how do they help the trade, commerce and industry of a country?

The hard fact is that the commercial insurance companies always keep most of their funds by way of fixed-earning investments (i.e. interest) and invest little or nothing in commercial or industrial undertakings because they regard the latter as too risky for them. It is almost a part of the general policy of the insurance companies to play safe and not to enter 'risky' ventures. They consider investment in trade and industry as 'risky' because the income from such sources varies with the rate of profit, whereas fixed-earning investments are almost certain and there is less likelihood of loss or variation.How can this kind of attitude and behaviour of the insurance companies build up a national Saving Fund of the national economy? This attitude can hardly be tolerated in an Islamic economy, where fixed-earning (i.e. interest) investments would be unlawful.

What ever the nature, safety or security of insurance funds, insurance business on these lines will be invalid and no amount of arguments and reasoning can justify this form of business which is deeply involved in interest *(Riba)*.

As far as 'Investment Fund' and 'Social Benefit Schemes' are concerned, their benefit is more imaginary than real. Firstly, who benefits from these 'Investment' and 'Benefit Schemes'? Secondly, Social Benefit Schemes involve either representation or direct co-operation, or active participation by the people who work together and have common interest. None of these things exist in commercial insurance.

(d) It is said that insurance provides security to many people in return for their premium money, but when we look into this argument we find many flaws and inconsistencies. The 'security' is unrealistic because indemnity is not always paid. If the instalments are not paid or discontinued, no indemnity is paid. And the insuree cannot be sure of his financial circumstances in the future. He may run into all sorts of financial hazards, or difficulties, and consequently may not be able to continue the payment of his premiums. In these cases, where is the security?

Thus the feeling of security is a farce because the whole superstructure of society is built on an uncertain hypothesis, if one brick falls or moves from its place, the whole superstructure of alleged 'security' tumbles down. Insurance companies provide this 'security' in return for premiums, but it is only because of the multiplicity of the insurees that it is in a position to make the security claim. This means that the insurer can only guarantee 'security' to an insuree if he is able to gather a large amount of money in premiums from thousands of insurees. But the insurance contract does not recognise (or depend upon) the multiplicity of contracts. It guarantees this security in absolute terms without reference to other insurees.

Thus, as far as the insurance contract with each individual is concerned, the 'security' element is more of an illusory character than a real one. Besides, it cannot eliminate the element of uncertainty or probability which exists in the nature of the phenomena of 'large numbers'.

Again, every insurance contract is subject to the health condition of the insuree. If any insuree does not fulfil the health standards required by the insurance company, he will not be issued with an insurance policy. Thus, it is wrong to say that the insurance company provides 'security' to the insurees in return for a premium. A man can be ready and willing to pay premiums but because of health standards, he may be deprived of this 'benefit' by the insurance company. The latter therefore, promises to provide such 'security' to those insurees who fulfil its health standards but not to all the people.

The law of insurance in the U.K., the U.S.A. and other Western countries is very clear with respect to the payment of compensation. The law asserts that

compensation must only be paid when the premiums are paid and in case of default no compensation will be paid. In all such cases, the insurees get nothing – their 'security' is unreal and illusory.

(e) It is a noble thing to work for the welfare of the individual and the community, and those who are engaged in such useful activities are the real benefactors of mankind. But it may be pointed out that as far as the insurance companies are concerned they have neither the intention nor is it their duty to do any such work because there is nothing in the rules of the companies or in the insurance contract of anything of this nature.

The 'supporters' claim that it provides 'peace of mind' to the insurees, but in non-occurrence of an event, the insurees get nothing and all their premium money is lost to them. In this case, mere 'peace of mind' does not seem very logical for the satisfaction of the insurees who have paid a lot of money. It is something which cannot be measured in terms of money, and the insurance company is a monetary agency, established to provide compensation in money terms and not in the form of 'peace of mind', which is psychological state of mind.

The insurance companies never advance such claims about securing 'peace of mind' or security for the individual insuree or doing welfare work for the community. It is, in fact, the 'supporters' of commercial insurance who are endeavouring to show the multifarious benefits of this form of business in order to legalise it in the Islamic system.

(f) Some claim that commercial insurance has many benefits for the individual and the community and it must therefore be lawful, but they forget that mere benefits of a system cannot make the system itself lawful. There are many benefits of alcohol but these do not make it lawful. This is because benefits of something are secondary to the fundamental principle of validity (*hillat*) and invalidity (*hurmat*) of Islamic *Shariah* as explained in an earlier chapter. If anything is against the basic principle of *Shariah*, then its manifold benefits cannot help to restore it to legality.

In order to determine the legality of a system or a thing we have first to see that it conforms to the principles of *Shariah*, and, secondly, that it is useful and necessary for the system. Thus, the determining factor of whether a thing or discipline should be or should not be adopted in the Islamic system is the code of *Shariah* as contained in the *Qur'an* and the *Sunnah* of the Holy Prophet of Allah, and not the benefits. Insurance is no exception to this rule. If commercial insurance satisfies the essential condition laid down by *Shariah*, it can be adopted as a useful discipline, but if it is found against those principles, it cannot be adopted in the Islamic system in spite of its advantages.

Some say that commercial insurance has more advantages than disadvantages, therefore they insist that on the basis of the general principles of *Shariah* it must be accepted in the Islamic system. But they forget that it is not yet proven that advantages of commercial insurance outweigh its disadvantages. The 'supporters' have greatly exaggerated its benefits. A scientific investigation will show that most of its benefits are more apparent than real, and in the long run, its social, economic and moral evils will be far more damaging than its benefits to the few who suffer some calamity.

It is said that the Holy Prophet allowed people to carry on their commercial dealings involving an element of *garar* (or *juhala*) according to the prevalent custom of that time so long as there were no quarrels and disputes among them. But they forget that people had been used to such dealings which, over many years, had become a habit with them. The problems of these dealings had to be tackled with great care and wisdom. It is a fact of human history that no reform can be introduced into any economy by one statute of legislative act. And this general observation over the centuries remains true for all times. Fully conscious of this historical process, the Holy Prophet, therefore, gradually introduced Islamic reforms into the economy of his own time. The people were long accustomed to so many forms of valid and invalid commercial transactions and they could not be stopped overnight. They were allowed for some time to carry on their business transactions according to their centuries old customs. As they grew stronger and firmer in their faith and fully understood the significance and wisdom of the law of *Shariah*, the Holy Prophet started to purge the economy of its manifold evils one by one. Finally, before the end of the Ministry, all invalid sale contracts and business transactions were disallowed while the valid forms of transactions were retained in the system. At the same time, general principles were laid down to

compensation must only be paid when the premiums are paid and in case of default no compensation will be paid. In all such cases, the insurees get nothing – their 'security' is unreal and illusory.

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In order to determine the legality of a system or a thing we have first to see that it conforms to the principles of *Shariah*, and, secondly, that it is useful and necessary for the system. Thus, the determining factor of whether a thing or discipline should be or should not be adopted in the Islamic system is the code of *Shariah* as contained in the *Qur'an* and the *Sunnah* of the Holy Prophet of Allah, and not the benefits. Insurance is no exception to this rule. If commercial insurance satisfies the essential condition laid down by *Shariah*, it can be adopted as a useful discipline, but if it is found against those principles, it cannot be adopted in the Islamic system in spite of its advantages.

Some say that commercial insurance has more advantages than disadvantages, therefore they insist that on the basis of the general principles of *Shariah* it must be accepted in the Islamic system. But they forget that it is not yet proven that advantages of commercial insurance outweigh its disadvantages. The 'supporters' have greatly exaggerated its benefits. A scientific investigation will show that most of its benefits are more apparent than real, and in the long run, its social, economic and moral evils will be far more damaging than its benefits to the few who suffer some calamity.

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determine the validity or invalidity of any contract or business transactions for all future times. Any discipline or contract which violates those principles is not accepted in the Islamic system.

Shortcomings of Commercial Insurance

Commercial insurance has a great many shortcomings and evils, some of which are summarised below:

(i) The benefits of commercial insurance are not distributed evenly among all groups of society.(3)

(ii) The insurance business has not always been made inside the framework of the law.(4) Successful legislative measures have been taken by the various governmernts, especially the British government, to remedy the defects of insurance, but they have not been very successful. Illegal 'policies' are still being issued by the insurance companies.(4)

(iii) The ignorance of the insurees and the complex nature of the policies have left the insurees at the mercy of the insurance companies and their agents.(4)

(iv) One of the greatest drawbacks of commercial insurance, especially industrial insurance, is the high percentage of lapses. Lapses have been heavy in Japan and Italy where the insurance business was run by the state, and also in America and Australia where it was under the system of industrial assurance. There is no compensation on the lapses of policies of short duration.(5)

The magnitude of lapses were illustrated by Janner in these words,"During the previous fourteen years (i.e. from 1920–34) nearly 100,000,000 policies had lapsed and their owners lost upwards of £100,000,000. The income of the companies concerned was £77,470,000, the management expenses and shareholders dividends amounted to £314,980,000. But policy-holders received only £271,600,000 and the interest funds were increased to £215,000,000. The dividends to shareholders have been more than doubled in this period." (6)

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3. Barou,N., *Co-operative Insurance,* op., cit., p.49
4. Barou,N., op., cit., p.53–4
5. Barou,N.,op., cit., p.56–8
6. *Journal of the Institute of Actuaries,* Vol.LXVI, p.320–331, quoted by Barou,op., cit., p.57

And Harcourt Johnstone, M.P. called the attention of the British parliament in March 1934 to the "gravity and extent of what he termed the 'organised swindle' of certain industrial assurance activities. He also pointed out that large sums of money due to the policy-holders all over the country were never paid." (5)

J. Murray Long described the state of affairs with regard to lapses in these words," It had to be admitted that lapsing in industrial assurance was heavy, it has always been and he was afraid it always would be so, and that for reason quite outside the control of the offices. It was not peculiar to this country (i.e. U.K.). Lapsing in industrial assurance was heavy in Japan and in Italy where the busines was run by the state. It was heavy in the United States of America and in Australia, where it was under the system of industrial assurance as it is practised, the majority of the policies effected lapse within a short time. In the case of the Refuge Assurance Company, it was found that in ten years from 1909 to 1918, 6,426,313 policies lapsed while 9,322,336 policies were issued." (6)

As a result of lapses, huge amounts are lost by the insurees in lapsed policies and enormous gains are made by the insurance companies. Lapses in the first few years are totally damaging because the insurees practically get nothing and all their money is lost. (5)

(vi) Owing to their ignorance, the policy-holders are also exploited by the agents and brokers of insurance companies.(5)

(vii) The policy-holders pay more than is necessary to cover the cost of services rendered to them by the insurance company.(7) It is estimated that about 40 to 44 per cent of the premiums is absorbed by expenses, commissions and profits, while the insured benefits by 50 per cent only, of the valuation surplus. Thus, there is great waste of premium monies.(8)

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7. Barou, op. cit., p.68
8. Barou, op. cit., p.60–62

(viii) That there is unequal distribution of the surplus of industrial insurance and also an unequal treatment of policy-holders .(9)

(ix) There is a good deal of profit-making and exploitation in commercial insurance. Investigations into the operations of industrial insurance companies have shown that their business is based on "grave exploitation of the policy-holders."

(x) In spite of considerable improvements in industrial insurance some of the defects have not yet been eliminated. "The legal compexity, the system of acquiring business through the agents, the numerous lapses, the unfair distribution and unequal distribution of surplus and the high expenses are the continuing problems of commercial insurance."

(xi) "Profit-making insurance displays all the features of a modern capitalist enterprise especially in its tendency towards monopolistic organisation. It is characteristic of the present methods of organisation of insurance business that competition between the leading concerns does not reduce premium rates but results in the building up of a costly system of getting business." "It is quite evident that at present the insured pays more than is necessary and economic, but he is apparently helpless to alter things."(10)

"The reports of the numerous committess on insurance reveal much misery and injustice. Considering the question in the contract, one would expect that profit-making insurance companies were started by entrepreneur shareholders who put up capital-form reserves, in order to balance the unresolved uncertainty in their clients' aggregate risks. This capital would now earn a super-normal reward as the companies have a monopoly position. Actually, when studying the history of the development of the large insurance companies,one discovers that the founders have subscribed astonishingly little capital to the business and their claim for profits cannot be justified from the capital point of view. "Primary accummulation" manifests itself in insurance probably more than in other branches of capital economy." (10)

9. Barou, op. cit., p.69–70
10.Barou, op. cit., p.74–76

Some writers have defended the huge profits of insurance companies on the grounds that "uncertainty is a disutility and the person who assumes it must be rewarded for doing so." According to them ,"assumption of risk by the insurer is the justification of profit-making insurance."(11)

But the reality is that, "as insurance institutions group, combine to offset the risks assumed, these risks become of a lower degree of uncertainty to them. Therefore, they are able " to relieve the insured of the greater part of his cost of uncertainty bearing and at the same time, to make a profit." The insurer makes a profit because he has become an uncertainty-bearer in the place of the person he insures, who now includes his insurance premiums among his ordinary expenses."(11)

As has already been explained, the essence of insurance is the grouping of risks in order to diminish them so that they might be covered by insurance reserves. Profit-making is not so much reward for taking over risks as for the establishment of an organisation for combining and deminishing them to a coverable proportion.

It can therefore be said that the "general character of insurance activities, which is collective to a very great extent and is based on the principle of numbers, does not justify the conduct of business as a profit-making enterprise. In view of long history of profit-making and exploitation of the insuree by the insurance companies, some have put the following questions about the future of profit-making insurance."(10)

Is insurance by the very character a business from which individuals should be permitted to make profit in the economic sense of the term? Or is it a business of such social importance that its costs to those whom it serves should be prime costs? In other words "should not the outlay for the service be limited to wages for those who are employed to conduct the business of insurance?

It is suggested that "the principles and practice of provident insurance can find

11. Barou, op. cit., p.80–82

its best expression in an insurance organisation formed by the insured for the satisfaction of their needs. Co-operative insurance is the best method for the organisation of popular insurance" (11) for the benefit and welfare of the insured without any profiteering or exploitation of the latter by the insurer."

16

CONCLUSION

This long discussion has at least shown that the Muslim jurists all agree on one thing, that the presence of ***riba*** (interest), ***maisir*** (gambling), ***garar*** (risk, probability or uncertainty), and ***juhala*** (unspecified and unknown element) in any business contract or dealing makes it unlawful. Whenever any of the four elements are found in any transaction, no matter in what form or shape, it invalidates that transaction. There is complete unanimity among the Muslim jurists on this point and there are no two opinions with respect to the invalidity of a contract which involves any of these four elements.

Though the jurists have disagreed among themselves on the legality or illegality of certain forms of commercial dealings or sale contracts, this does not materially or substantially affect the practical significance of their complete agreement on the illegality of sale contracts containing the above-mentioned four elements. They have minor disagreements on the details of the terms and conditions of certain sale contracts as we pointed out earlier with respect to sale ***salam***, ***saraf*** and ***ariya*** but it does not affect the fundamental rule with regard to sale or contracts.

As discussed before, ***Shariah*** has laid down basic rules to determine the validity of a thing, if anything contravenes those rules of ***Shariah***, it is unlawful. No amount of argument with respect to the need, necessity or common use or practice of a thing can make it lawful if any of the four unlawful elements is present in it. We have to judge the validity or invalidity of commercial insurance on the same principle. In order to find this, we have to find answer to the following questions:

1. Whether any unlawful element (or elements) is (or are) present in commercial insurance?
2. If such an element or elements are present in commercial insurance, what is the maximum degree of the unlawful elements acceptable to ***Shariah***?
3. Does commercial insurance contain the maximum degree of unlawful

elements acceptable to *Shariah*? Let us deal with these questions one by one.

1. Whether any unlawful element (or elements) is (or are) present in commercial insurance?

Analysis of insurance contract will show that all the four unlawful elements are present in it in sufficient degree to render it invalid and illegal in an Islamic society.

(a) Interest *(Riba)*

Riba is present in the commercial insurance business in all stages of its business from the calculation of the premium to the compensation to the sufferer of a calamity. The entire funds of the insurance company are invested in fixed-earning (i.e., interest) investments and all the benefits paid to the insurees who have suffered a peril contain an element of *riba*. There is no denying the fact that most, if not all, of the earnings, of the insurance company come from interest. On average, insurance companies invest over two-thirds of their funds in fixed-interest stock and about 11 percent in property, most of which bring interest.

(b) Gambling *(Qimar)*

The entire basis of the insurance contract is on the happening of an uncertain event which may happen or may not happen at all. It is exactly like betting or lottery. The nature of permium money in commercial insurance is exactly like the stake money in gambling or betting. Likewise, the amount of compensation is as illusive as premium money. In spite of great progress in the science of statistics and the theory of numbers, the element of probability (i.e. gambling) cannot be eliminated from commercial insurance. Calculations in gambling are based almost on the same principle as in commercial insurance in order to ensure profits for the house (or bank). And insurance company, like the house in gambling, is rarely the loser.

Furthermore, insurable interest has and will always remain an enigma, especially in life insurance, for the insurers as well as for the insurees. The nature of insurable interest will always present problems of the same kind as

gambling or wagering.

Many eminent economists do agree with the view that commercial insurance is a form of gambling. And gambling is clearly prohibited in the text of the *Qur'an* and *Sunnah* of the Holy Prophet, and all Muslim jurists are also in full agreement about this.

(c) *Garar*

The element of *Garar* (risk probability leading to uncertainty of the final outcome of the insurance contract) is very dominant in commercial insurance. This risk probability is present in the total business of commercial insurance involving premiums, indemnity and the insurable interest. The element of doubt and uncertainty will always over shadow these variables because their fate is finally dependent on events which may or may not happen. If the event happens, the nature and extent of the damage has to be estimated.

Thus, both the parties in the contract are totally in the dark with regard to their obligation and liabilities to each other owing to the uncertain nature of the risk. The presence of an element of *Garar*, therefore, is evident in insurance business.

(d) *Juhala*

The insurance contract also contains an element of Juhala. As explained under Garar, the element of uncertainty is also very predominant in the commercial insurance business. As the basis of the insurance contract is the probable peril which cannot be predicted, an element of uncertainty is unavoidable.No amount of progress and development in the science of statistics or theory of probability can assure us that the nature and extent of the peril is determinable before the happening of the event.

Again, an element of unspecified quantity both in respect to premiums and compensation is present in the insurance contract. The nature of insurance business is such that the element of uncertainty is indispensable and cannot be

avoided under any circumstances.

Thus, it can be said that all the four unlawful elements prohibited by the *Qur'an* and *Sunnah* of the Holy Prophet i.e. *riba, qimar or maiser, garar* and *juhala* are present in the insurance contract.

In addition, elements of exploitation and unfair dealings are also present in the commercial insurance business. As has been explained earlier, there is plenty of evidence that suggests considerable exploitation and unfair play in the business of commercial insurance.

2. What is the maximum degree of the unlawful elements acceptable to *Shariah?*

After showing that there is a positive degree of all the unlawful elements in the insurance contract, it would be quite logical to ask what is the maximum degree of the unlawful elements acceptable to *Shariah.*

This question is totally irrelevant with respect to *riba* and gambling which are completely forbidden by the explicit text of the *Qur'an* and *Sunnah*. The verses of the *Qur'an* are clear and the prohibition of the two elements is absolute without any shadow of a doubt.

Riba is forbidden in all its forms; in money or in kind, in cash or in loan, in business or in personal dealings. Whether it is taken in large quantities or in small ones, i.e.in millions of pounds or pennies. It is totally forbidden because the nature of *riba* remains unaltered in all these forms. Change in form of the business contract, from a simple transaction between two individuals to the most modern sophisticated insurance dealings, or in the nature and extent of the amount involved, from an ordinary loan of few pounds for consumption purposes to huge amounts for commercial purposes, does not affect the nature of *riba.*

Riba and gambling are forbidden under all circumstances, whether they lead to disputes and quarrels among the parties or not. These are the physical and

objective symptoms of the disease which the *Holy Qur'an* has referred to, but these are not the sole causes or determining factors of the prohibitory order. This is exactly like alcohol which intoxicates people and keep them away from *Salat* and the rememberance of *Allah (zikr-Allah),* but the latter is not to be taken as the sole determining factor of this prohibitory order. Alcohol is prohibited, irrespective of its effect, whether it is taken in any small or large quantity, or whether or not it intoxicates person. Similarly, *riba* and gambling are prohibited whether or not they lead to disputes among the people. Furthermore, it is extremely difficult to relate the prohibitory commandment regarding riba and gambling to any quantitive measurements because they belong to the species which cannot be expressed in scales of measurements or weight.

As for the other two unlawful elements of *Garar* and *Juhala,* some jurists have classified them as (a) too much, (b) moderate, and (c) very small. The first and second, i.e. too much and moderate amounts of *Garar* and *Juhala* are definitely unlawful and the last, i.e. very small amounts of *Garar* and *Juhala* are controversial. But all the jurists agree that the six forms of sale contracts, mentioned earlier are unlawful. These six forms of sale contracts were prohibited by the Holy Prophet.

The jurists also agree that the prohibitory factor in these six cases was the presence of the element of *Garar* and *Juhala.* These sale contracts were absolutely forbidden by the Holy Prophet because of the presence of *Garar* and *Juhala* in them.

Now we have to compare the extent of *Garar* and *Juhala* in commercial insurance with those six forms of sale contracts prohibited by the Holy Prophet in order to find out the legality or illegality of the former.

The first sale contract prohibited by the Holy Prophet was "sale of goods not yet made", for it involves probability and doubt as to the quality and quantity of the goods in question.It fully applies to commercial insurance which accepts price from the insuree in the form of premiums in return for indemnity on the occurance of an uncertain peril. The thing promised in exchange for the price is not in existence nor is its existence certain and even the nature and extent of

the probable peril, the determining factor of the indemnity, is unknown. Thus commercial insurance has a much greater degree of *Garar* and *Juhala* as compared with the first sale contract prohibited by the Holy Prophet.

The second sale contract prohibited by the Holy Prophet was "the sale of goods not in possession of the seller" owing to the existence of uncertainty and doubt. Our explanation under the first sale contract will show that the amount of *Garar* and *Juhala* in the insurance contract is much greater than in the second sale contract.

The third sale contract which was prohibited by the Holy Prophet was 'the sale of fruit not yet ripe' because of the element of conjecture and probability. The same doubt as to the nature and extent of the probable peril exists in the insurance contract. The fourth sale contract was ' the sale of products that cannot be easily given or taken possession of ', and was prohibited by the Holy Prophet owing to the want of certainty. An element of ' absence of certainty ' or ' want of certainty' is definitely present in the insurance contract. There is no possibility that anyone can guarantee the nature, extent or the time of the peril. Hence we will not be wrong in concluding that an element of *Garar* and *Juhala* of this kind in form of sale prohibited by the Holy Prophet does exist in the insurance contract.

The fifth sale contract prohibited by the Holy Prophet was, 'The sale of unspecified (in price, quantity and quality) goods, because of the existence of unknown qualities in the subject of the sale. The discussion under the 'fourth sale contract' must have by now clearly shown our readers that the "unknown quantities" are not only present in the insurance contract, but are present in a very high degree with respect to the nature of the probable danger and the resulting compensation for the sufferers.

The sixth unlawful sale contract is, "the sale of goods with an advantage to any party", because of exploitation and unfair bargaining. As we have already explained, the history of insurance in general, and British insurance in particular, provides us with ample evidence of exploitation and unfair bargaining in insurance business.

In view of this discussion, there is no doubt that an element of *Garar* and *Juhala* is present in modern commercial insurance in a sufficiently high degree to make it unlawful in an Islamic society.

3. This brings us to the final question; does commercial insurance contain the maximum degree of unlawful element, or elements acceptable to *Shariah?*

As far as the first two elements of ***riba*** and gambling are concerned, consideration of their presence in terms of degree, either high or low, is absolutely irrelevant, as has been explained earlier. The mere fact that ***riba*** and gambling are present in the insurance contract is sufficient to render it invalid and unlawful.

As for the other two elements of ***Garar*** and ***Juhala,*** commercial insurance does contain quite a high degree of these unlawful elements. In our judgement, as explained earlier, the degree of these two elements present in commercial insurance is too high to be acceptable to ***Shariah***.

The risk element and the uncertainty of the final result is too great to allow anyone to say that the degree of ***Garar*** and ***Juhala*** is minimal. Therefore, we have to conclude by saying that the insurance contract does not contain a low degree acceptable to ***Shariah***, but, on the other hand, possesses quite a high degree of the unlawful elements which makes it invalid and illegal.

أَهُمْ يَقْسِمُونَ رَحْمَتَ رَبِّكَ ۚ نَحْنُ قَسَمْنَا بَيْنَهُمْ مَعِيشَتَهُمْ
فِي الْحَيٰوةِ الدُّنْيَا ۚ وَرَفَعْنَا بَعْضَهُمْ فَوْقَ بَعْضٍ دَرَجَاتٍ لِيَتَّخِذَ بَعْضُهُمْ
بَعْضًا سُخْرِيًّا ۗ وَ رَحْمَتُ رَبِّكَ خَيْرٌ مِمَّا يَجْمَعُونَ

SECTION THREE

MUTUAL AND CO-OPERATIVE INSURANCE

أَهُمْ يَقْسِمُونَ رَحْمَتَ رَبِّكَ ۚ نَحْنُ قَسَمْنَا بَيْنَهُمْ مَعِيشَتَهُمْ
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SECTION THREE

MUTUAL AND CO-OPERATIVE INSURANCE

1

MUTUAL AND CO-OPERATIVE INSURANCE

Insurance based on the principle of mutuality and co-opeartion is the natural, effective and most comprehensive solution to the multifarious insurance problems facing man in the modern environment within the acceptable Islamic law. The participants pay contributions and those who suffer loss benefit from the common fund. The policy-holders are themselves the insurers as well as the insurees in co-operative and mutual insurance. The motive is not profit-making but self-helping through co-operation with other members of the society or company. All the members get together and organise the mutual or co-operative society or company for the benefit of its members.

This form of insurance is the alternative available to Muslims to replace modern commercial insurance. It is , in fact, the same old system which has been used by their ancestors to insure their ships and cargoes on the high seas for centuries. This is the only way to solve their insurance problems and to avoid the pitfall of gambling, uncertainty and probability.

It is argued that co-operative insurance cannot meet all our insurance needs because of its limited scope and means under the existing statutory laws. Also, in co-operative insurance, profit is divided between the policy-holders and it cannot be called a non-profit-making organisation.

But this criticism of co-operative organisation is based on its present organisation and function under the existing statutory regulations. Muslims can borrow the existing system based on the Western statutory regulations and make its own statutory laws to improve it and remove its weaknesses with respect to the scope, means and powers of the co-operative insurance societies. This may also, if desirable and necessary, improve its organisation and functioning in the light of the Islamic principles.

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As far as the decision of profit among the shareholders is concerned, if it is found necessary, desirable and beneficial, it can be stopped completely, or the amount of the profit of each shareholder can be reduced or limited to a reasonable percentage. In addition, a permanent reserve fund can also be created and a certain fixed proportion or percentage of profits can be reserved annually for this fund to meet the annual insurance needs of its members.

Moreover, if any percentage of the profit is shared by the policy-holders it goes to its members and is not grabbed by a third party as happens in modern commercial insurance. If there is any surplus profit and the memebers find it desirable and beneficial, there is no harm in the division of such profits among the policy-holders. In this way there is neither profiteering nor exploitation of the members by a third party.

Even if one co-operative insurance society has limited means and resources, as a member of a federal co-operative system, its powers and resources can be immense. There will be hundreds and thousands of co-operative insurance societies all over the country to meet the multifarious insurance needs of the industrial and agricultural populations, forming a net-work of federal co-operative insurance systems. Though each co-operative insurance society may be small in size, scope and means, its total country-wide resources, in view of the large numerical strength, will be enormous and a sure guarantee for the insurance needs of the individual and each industry.

Furthermore,co-operative insurance will not be the only insurance organisation in the country, but will be assisted by large number of mutual insurance organisations all over the country. Total insurance needs will be fully met by the two forms of insurance organisations which will be supplementing each other's work indifferent regions of the country.

Above all, the social security system of Islam will be fully operative, meeting the ordinary needs of the people, e.g. the unemployed , sick, old, widows, invalids, travellers in financial troubles, people in debt, etc. Many of the needs of the people will be fully met by the social security system and, if there are any other insurance requirements outside its scope, the mutual and co-operative insurance can adequately and effectively take care of them. Thus,

in reality, much less reliance will be placed for insurance needs on co-operative insurance because it will be operating as a secondary source of insurance in the triangular system of insurance in the Islamic economy.

We are sure that this triangular system can very successfully meet the legitimate and lawful insurance needs of the people in the Islamic system without including any unlawful elements and this is explained in the following pages.

Mutual And Co-operative Insurance

There are four kinds of insurance institutions based on the method of control exercised by the members.

1. The Joint Stock or Proprietary Companies

In this form of insurance, the ownership and control of the companies is in the hands of the shareholders. It is most organised and stable form of private insurance. Its chief motive is profit-making. The shareholders have invested their capital for the sake of profit.(1)

2. Mutual Insurance

These institutions are organised on the principle of membership. Usually there is no share capital and shareholdering. The management and control are in the hands of the insured members who are the policy-holders of the society. In fact, the insurers and the insured are the same people. Its main purpose and nature is mutual security and not profit-making.(1)

3. Co-operative Insurance Societies

These societies are organised on general co-operative principles. The institutions are controlled and managed by the members of the co-operative societies. The members subscribe to the shares of the society or guarantee its capital and make use of its insurance services. Again, the motive of co-operative society is mutual security for its members and not profit-making.

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1. Barou,N., *Co-operative Insurance*, London,1936,pp.36–37

4. The Mixed Companies

These companies are controlled and managed by the stock-holders who may not be the policy-holders. Sometimes the policy-holders may be represented on the board. The purpose of the organisation of these companies is profit which is shared among the stock-holders of the company, but sometimes holders may also participate in the profits.

We are concerned with the two types of insurance, namely, mutual and operative insurance.

(a) Mutual Insurance and the Principle of Mutuality, its Origin and Meaning

The basis of insurance in its original form seems to be the spirit of self-help and mutual security against a common danger. People organised such institutions or groups to protect the interests of their members from any danger or loss. It signifies a feeling of self-help and mutuality among the members. All the members co-operate in safe-guarding the interests of its individual members. If any individual member is faced with a calamity beyond his means, all the members contribute to meet his loss. It is organised from within and not from outside as in case of commercial insurance.(2)

It is formed to cover its members for specific risks which arise out of some trade or profession. There is no profit motive at all. The policy-holders are themselves the organisers, controllers and managers of the entire business of the association. They distribute the loss of a member inflicted with any calamity among all the members and make no profit. It is thus organised by the members, who are also the policy-holders, on a non-profit basis.

A mutual insurance society may be defined as "an unrestricted union formed by the insured themselves who undertake to pay, on an agreed scale, periodical contributions for the purpose of covering losses sustained by some of them in the cases of stipulated future contingencies, such losses being pre-rated periodically among all members."(2)

The term mutuality is used in two senses, "first, as a method of distribution of income, and second, as a method of joint guarantee. In the first sense, it deals with the distribution of income over a given period of time. Pure mutuality affects such a transfer of income between the members in each year." Pigou says," that the deviation of collective consumption in each year from average collective consumptions is spread evenly among them. By saving collectively instead of individually, a group of people can greatly lessen the amount of saving that is required, in order to reduce the variability of the representative man's consumption in any given degree."(3)

In the second sense it is used as a method of joint guarantee against loss of any of its members. "The members of a group guarantee jointly that if any of them suffers a disaster, he will receive a certain sum of money to help him to meet the loss." The mutuality theory has taken stock of the fact that in its early stage insurance was organised to a great extent on a mutaul and semi-mutual basis. This theory emphasises the social value of insurance and defines it "as a brotherhood of men who unite against the all-destroying effects of the unfettered forces of nature."

The few writers of the Utilitarian School who devoted some attention to insurance, came very near the definition of the mutuality theory. They thought that the great advantage of insurance lay in the fact that "when applied in its natural and most common way, it considerably alleviates the misery of mankind. The gratification of human needs and wants can, to a great extent, be fostered by insurance, which they describe as "a kind of hedging against extreme misfortune by an agreement between a certain number of persons, namely those who take policies in the same office, that those who are fortunate shall support those who are unfortunate."(3)

Commercial insurance as practised in modern times, is totally different from normal or co-operative insurance in many respects. Firstly, it is organised by members of an outside party who are not themselves the policy-holders. Secondly, it is not controlled by the insured, thirdly, there is no conscious or active participation by the insured, fourthly, the risk is transfered to an outside

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1. Barou, op. cit., p.83
3. Pigou, *Wealth and Welfare*, p.408–10

group of persons and is not shared by the insured, fifthly, there is no self-help or humanitarian nature in it, sixthly, there is no element of mutuality and co-operation in this form of insurance; and seventhly, there is "nothing of a collective nature because the combination and offsetting of risks by the underwriters concerns only the insurer and not the insured".

It seems, therefore, unreasonable to emphasise the existence of mutuality or conscious participation in commercial insurance. It is different form of insurance and does not possess the basic elements of co-opeartive or mutual insurance. "How can all forms of insurance be mutual when this mutual character is actually unknown to the insurer and insured? What is the value of an economic interdependence between all the insured, and between the insured and the insurer, of which neither of them is aware? Such unconscious mutuality is of no use or value because it finds no manifestation in economic action. Only where it becomes a conscious expression of organised co-operative or mutual effort, only when it is expressed in a new form of social organisation, only then can mutuality become a real force in insurance and in other spheres of human economic activities."(4)

Organisation of Mutual Insurance Societies in Modern Times

Mutual insurance is organised in the sphere of social insurance in many European countries. It has been very successful in the field of worker's compensation and mutual sickness insurance etc., and such societies are found practically everwhere in Europe. These societies have been organised in different forms. Firstly, there are the private mutual societies consisting of members belonging to different occupations. Secondly, large federated or affiliated societies consisting of local bodies and operating on the lodge system. Thirdly, house societies working in co-operation with an industrial firm and often enjoying the support of the employers. The membership of these societies is voluntary as well as obligatory, if required by the employer. Fourthly, trade unions providing insurance against sickness as a part of their welfare scheme.(5)

4. Barou, op. cit., p.41–2
5. Barou, op. cit., p.90–91

On the European continent, there is greater tendency among the employers to co-operate with mutual societies for the object of covering their liabilities under the law. In Sweden and Denmark there are many employers' mutual insurance societies which transact by far the largest share of the insurance business of the country. France, Switzerland, Belgium, Holland and Italy have thousands of small mutual insurance societies which are working very successfully. In many of these countries, these societies are greatly favoured both by the government and the employers.(5)

In the U.S.A., mutual insurance societies have been very successful in their rural activities. "Farmers have made extensive use of it and success which they have achieved has encouraged them to attempt other enterprises on a co-operative basis. Of particular significance, however, to those interested in the activities of farmers should be the fire and windstorm insurance companies classed as grain dealers and millers' mutuals, as well as the mutual casualty companies, which offer employers liability protection and other casualty protection. The services of these groups of 'mutuals' are of direct and vital interest to co-operative marketing and purchasing associations as well as to the individual farmer. Apart from the farmers, town-producers in the U.S.A., have also introduced mutual insurance to cover the different risks of their enterprise."(6)

Classification

Many types of mutual insurance societies have been organised by different groups and classes of people and different motives in various countries, but these can be classified roughly in six groups.(7)

1. Public or private society.
2. Rural or urban;
3. Independent producers or wage-earning people;
4. Big or small societies;
5. General or special societies, and
6. Assessment plan or Advances premium-plan societies.

6. Barou, op. cit., p.90
7. Barou, op. cit., p.92–94

1. Public or Private Insurance Societies

The mutual societies organised on a voluntary or compulsory basis are of two types, public or private. The former is formed by the state for the people of a certain administrative area, while the latter is organised by the policy-holders themselves according to the principles of mutuality.

2. Rural or Urban Societies

Mutual insurance societies operating in the rural areas provide cover against risks quite different from those of the urban societies and are, therefore, organised or operated on a different basis.

3. Independent Producers or Wage-earners

In former times, private mutual societies were organised mainly for humanitarian purposes but now these are formed to meet the economic needs of their members. Various types of mutual societies are formed – farmers, wage-earners, landlords, manufacturers, etc. – to meet the insurance needs of their members.

4. Big or Small Societies

These types of societies came into existence owing to the difference in social status of members. The small societies are generally formed for social motives and are very popular among the working people in the town and villages.

5. General or Special Societies

This classification is due to the sphere of the operation of each type of mutual society. The societies which provide cover against different kinds of risks, e.g. fire, life, burglary, motor-car, etc., are called general, and those which operate in the specific branch of insurance are called special.

6. The Assessment Mutual and the Advanced Premiums

This classification results from the mutual method of collecting the levies and covering losses. In the Assessment Mutual Societies the members contribute a fixed amount agreed upon in advance in case of any calamity falling upon a member.

This method has three main weaknesses. First, its premiums are not based on the ascertainable degree of risk. Second, these societies have no reserves and are therefore in a very weak position when many accidents occur simultaneously. Such societies endeavour to keep the cost of insurance for its members to the minimum and do not keep any reserve. Third, it is the lack of consistency in the cost of insurance which is due to lack of reserve.(8)

In the advanced premium plan, the estimated premium is paid in advance for one year. In case of losses the members are likely to pay an additional premium and if over-charged they are paid back a dividend. These societies have almost the same shortcomongs as the assessment mutuals.

Mutual insurance societies are formed to provide the ordinary worker with insurance facilities and to free them from the exploitation by the commercial insurance companies. These societies help to diminish the risk covered, and reduce the cost and the number of lapses. They also raise the moral standard of its members through co-operative spirit, mutual partnership and sense of responsibility.(9) In fact, a mutual insurance society can be a very useful and effective replacement of commercial insurance as subsdiary and supplementary to co-operative insurance and a state social security system.

Main Characteristics of Mutual Societies

1. A mutual insurance society or company has no capital stock. It has no share capital and no shareholders. Thus, legally no one has any proprietory interest in it.

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8. Barou, op. cit., p.94–5
9. Barou, op. cit., p.365

2. A mutual society or company is owned by its policy-holders, and the directors responsible for its management business are selected by them and hold offices at their authority.

3. Non-profit making is the other salient feature of mutual insurance societies. There is neither share capital nor dividend on capital. Mutual societies income is used to meet the cost of operations and to provide cover against risks to the members. If there is any surplus in any year, it is distributed proportionately among the policy-holders as dividends or bonus. Some societies may keep a part of it as reserve fund to meet cases of emergency. This reserve fund belongs to the society as a whole and introduces an important element of co-operative organisation to mutual societies.

4. A mutual insurance society is run by the insurees themselves and the premium instalments are only to underwrite losses. The amount of premiums is therefore small and within the means of ordinary people. The premium is defined as the sum to cover expenses in cases of loss. As such, it is a no profit, no loss institution.

5. There is no exploitation or profiteering partly because the insuree is only paying his share into the common fund, and partly because there is no third party to usurp someone's property or capital. The insurees are themselves the insurers.

6. The participants pay contribution and, those who suffer, get compensation of their losses from their common fund.

7. There is no intermediary or third party or agent between the insurees and the insurer because the policy-holders are themselves the insurers who have formed a common fund to face common danger.

8. Mutuality and co-operation are the basis of this form of insurance. Each insuree co-operates with other insurees to lessen the effect of a calamity which may have fallen upon any one of them.

9. The mutual insurance society has right to insuree's wealth. In fact, there are two insurance contracts in case of mutual insurance.(a) One contract is between the mutual insurance society and the insuree and (b) the other contract is between each individual insuree and the insurees in totality. All the insurees stand guarantee against the loss of each insuree. The principle behind mutual insurance is very comprehensive and is not limited to the mere paying out of compensation to those who have suffered a loss, but goes far beyond, sometimes beyond the limit of its own common fund. Its right stretches to other insurees' wealth as well. This is why it is said that there are two contracts at one and the same time in mutual insurance.

10. The insurees have freedom in the selection of their own agent or agents who work for and not against their interest.

11. Co-operation is voluntary and not compulsory.

12. The personal element has played a leading role in mutual insurance. The policy-holders themselves form the insurance company or society and are responsible for its success or failure. There is no regular contact between the members and the society. They do not form joint association, but co-operate only to achieve temporary objectives. If any member does not renew his insurance he ceases to be member. Thus, a memeber remains a member of mutual insurance so long as he remains a policy-holder. He has no permanent connection with the society like the shareholders in a co-operative society.

13. There is no permanancy in mutual societies because these are not business enterprises but are only unions of individuals formed by a contract for mutual service. The only link between them is the payment of contribution in return for a service. The relationship comes to an end when the service or services have been rendered. (10)

Mutual societies are like co-operative societies as far as their non-profit basis is concerned, but differ from the latter in the matter of their organisation and operation.

"A mutual insurance society which operates with a capital or with individual reserves, on the principle of fixed premiums and fixed policies, and on a profit making basis, is a co-operative insurance society: mutuality and capitalisation thus form the co-operative entity. Mutual insurance is the embryo of co-operative insurance, and if conducted on proper lines, can grow and develop into co-operative insurance of an effective and progressive type.(11)

The increasing competition with big commercial insurance companies, which are making huge profits from insurance business, has adversely affected the progress of mutual insurance, especially the urban mutual societies. A comprehensive network of agents and the wide publicity of the big insurance companies have done great damage to mutual insurance. Besides this, many commercial insurance companies show to the public that they are the real 'mutuals' and can provide better service than the small mutual societies.

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10. Barou, p.101–102
11. Barou, op. cit., p.104

2. A mutual society or company is owned by its policy-holders, and the directors responsible for its management business are selected by them and hold offices at their authority.

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10. Barou, p.101–102
11. Barou, op. cit., p.104

The survival and the success of mutual societies depends on their better organisation and efficient operation. They must reorganise their structural and operational activities and form a nation-wide federated system of popular insurance on a non-profit making basis and work on a more permanent basis to co-operative lines.(12)

12. Barou, op. cit., p.105

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CO-OPERATIVE INSURANCE

Co-operative insurance, like mutual insurance, is a very beneficial institution and can very successfully achieve the objective of security and guarantee against common danger for the employees of a particular trade or profession. Employees can form a co-operative insurance society or company which can be organised and managed by the policy-holders who are also the shareholders. The insurees themselves look after their own monies, investments and other interests. They pay premiums to cover their own losses without the help of any intermediary as in case of commercial insurance.

There is no exploitation nor any other element of doubtful nature and it is perfectly within the guideline of the Islamic Law. It is just a co-operative organisation or combine of ordinary citizens to create a fund to pay in and pay out in case of loss or calamity. In co-operative insurance, like mutual insurance, the insurance contract is between the one and the same people, because the insurees are the policy-holders as well as the shareholders of the co-operative insurance society.

Co-operative insurance is usually confounded and confused with mutual insurance even by many economists. This confusion is the result of two things. Firstly, it is due to the manner in which the term co-operation is used in economic literature, and secondly, it is due to the lack of an accepted definition of insurance. The misapplication of the term 'co-operation' has also been responsible for the erroneous view that all types of insurance are co-operative. In view of this misapplication and confusion it is now generally considered that commercial insurance is co-operative, which is totally untrue. If this were true then what is the difference between co-operative and non- co-operative insurance? (1)

1. Barou, op. cit., p. 106-110.

Definition:

Co-operative insurance is merely the application of the co-operative principles to the field of insurance. "The aim of co-operative organisations is to establish a business enterprise vested with continuity and permanency and not to be dependent on any of its individual members." This is the main difference between a co-operative and a mutual insurance society.

A general definition of co-operative insurance containing all its essential elements, may be given as follows, "Co-operation is a voluntary organisation with unrestricted membership and collectively owned funds, comprising wage-earners and small producers in towns and country, for the establishment of enterprises under joint management with the purpose of improving their household and/or business economy or creating facilities for work; it is built on a democratic basis of equality and common interest, and surpluses produced are allocated to reserves or distributed among the members in proportion to the utilisation by them of the facilities provided by the organisation." (2)

The Main Features of Co-operative Insurance

The definition of co-operative insurance given above contains legal, social and economic elements which are explained in the following:

1. Legal Elements

The main legal elements of a co-operative institution is firstly that it is a voluntary organisation and is formed in the interest of its members. (2) Thus, co-operative insurance society enjoys an advantage over private commercial insurance companies which lack a personal relationship between the policy-holder and the insurance institutions. Another element of great advantage is the sense of loyalty and responsibility of its individual policy-holders. This conscientious collaboration is vital for the successful operation and working of the co-operative institution. (3)

2. Barou, p. 113 - op. cit.,
3. Barou, op. cit., p. 114.

The presence of a personal element in co-operative insurance and of the personal relationship between its members helps to reduce and practically almost eliminate the 'moral hazard' inherent in insurance policies. It also helps in increasing the efficiency and reducing insurance costs in various ways.

Secondly, co-operative insurance is organised on the basis of membership which is unrestricted. Anyone can become its member without any discrimination between occupations or localities of greater risk, as is the case with private commercial insurance companies. As such, it is not faced with the difficulty of defining insurable interest because it only insures its own members and tries to serve them and safeguard their interest.

Thirdly, it has the support of the collective capital of the whole organisation of the co-operative movement. Fourthly, in view of the competition with big, well-established private insurance companies with huge funds, it is not possible for independent enterprises of individual members to survive. Co-operative insurance, is therefore, organised on a federated basis with a central co-operative body linked with thousands of branch co-operative insurance societies. Thus, its co-operative form of organisation from the top central body to the bottom co-operative insurance society of each area, gives it great strength and financial power. (4)

2. Social Elements

Co-operative insurance is a collective enterprise, but is based on the personal interest of the insured. The working of these societies has shown that insurance business "can be done better, cheaper and more safely, through the joint efforts of their members." The social elements which have played a prominent part in co-operative insurance are " the social grade of the membership and the principles of democracy, equality, joint management and mutual service in the organisation of co-operative bodies." (5)

In practical life, the working class people find it impossible to select an

4. Barou, op. cit., p. 115.
5. Barou, op. cit., p. 116.

insurance company and have practically no choice in such matters. The modern techniques of convassing and the black magic of advertising and the tricker of an army of agents of the commercial insurance companies give little chance to the workers to select an insurance company of their own choice. Co-operative insurance comes to the rescue of such people. It is less expensive than ordinary insurance with any private insurance company and can be subscribed on better terms than profit-making insurance by insurance companies. (6)

Co-operative insurance is organised on a democratic basis. Each member has one vote at the general meeting of the society. He even participates in the operation and general management of the co-operative society by electing its board and its officers. Co-operative societies are also established on a joint management basis which makes co-operative insurance cheaper than any other form of insurance , especially in rural areas where the officers are honorary.(7)

3. Economic Elements

In order to find the economic elements of co-operative insurance, we have to study those factors which embody it. The objectives of the co-operative insurance societies, its business character, the method of setting up new enterprises and of distributing profits, etc.

The question of whether and how far co-operative insurance business can be accommodated in the co-operative organisation needs to be considered. As we know, the entire basis of insurance rests upon the plurality of numbers. The larger the number of policy-holders, the cheaper and safer will be the insurance. Thus, co-operative organisation will be a very suitable method for insurance.

Co-operative insurance has two main economic objectives, insurance of the personal requirements of the members and insurance of the trading interests of co-operative organisation. (8)

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6. Barou, op. cit., pp. 118-19.
7. Barou, op. cit., p. 120.
8. Barou, op. cit., pp. 121-2.

Co-operative insurance creates a new power and a new enterprise much stronger than the sum of these individual efforts – capable of providing cover for much greater risk than the sum of the separate risks, which the members of the insurance societies seek to avoid. (8)

A limited portion of profit is distributed among the share-holders and the surplus is divided between the policy-holders in proportion to their contributions to the creation of the surplus. (9)

Co-operative Insurance and other Types of Insurance

1. Co-operative insurance is a permanent organisation built on a relationship much deeper than the mere casual relations of the policy-holders as in a mutual insurance society. Also, the members of a co-operative insurance society have joined together with the object of a common business. Mutual insurance,on the other hand, lacks stable organisation and is formed for a specific object. There is no share capital in it and profits are not divided, whereas in a co-operative insurance, there is share capital and profits are usually divided among the share-holders.

2. The Ordinary Commercial Insurance Company

In co-operative insurance there are no clients, other than the shareholders, and each member is a shareholder as well as policy-holder. All participate in the capital of the society and receive service of insurance from it. It is not a profit-making body. It distributes profit, if any, among the members.

Legally, the co-operative insurance society is more like a commercial insurance company with fixed premiums than a mutual insurance society. The essential difference is that the co-operative insurance society distributes its surplus among the policy-holders in proportion to the premiums paid by them, while in a commercial insurance company, it is distributed among the shareholders in proportion to their shares. The co-operative insurance societies are built on share capital or guarantee capital collected in subscriptions from the members.

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9. Barou, op. cit., pp. 123-126.

The capital and the reserves built from the surplus are the foundation of co-operative insurance societies. The members pay fixed premiums and never have to pay periodically to cover the losses of the society. (9)

3. Public Insurance

Co-operative insurance also differs from public insurance . It is voluntary unlike public insurance, for there is no obligatory membership in a co-operative society. The members can leave it whenever they want.

It is managed by the members in their own interest and not by an outside authority as in public insurance which is managed in the interest of a third party. Co-operative insurance is jointly managed by the members who democratically elect the managing board.

But in modern times, co-operative insurance has lost its co-operative and mutual essence. The principle of mutuality has ceased to apply to the large-scale co-operative organisations. It is because the co-operation is no longer mutual. It has 'outgrown' mutuality and 'the co-operative societies of today are corporate bodies' and separable from their membership. (10)

Co-operative Insurance Societies

Consumers' co-operative insurance societies differ greatly in their organisation and field of operation in various countries. However, they can be divided into two main groups. (11)

(a) General societies which operate in various fields of insurance .

(b) And special societies which operate in one branch of insurance only. Another division of consumers' co-operative insurance society is with regard to the units of which they are composed.

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10. Barou, op. cit.,p.109–10.
11. Barou, op. cit.,p.127.

(a) Primary Co-operative Insurance Societies

Primary societies are established by individual members and function more or less on the same lines as primary co-operative societies in other fields of co-operative activities.

(b) Secondary Co-operative Insurance Societies

Secondary societies are usually formed by local co-operative societies, trade unions and other labour organisations with or without the participation of individual members.

(c) Third-Grade Co-operative Insurance Societies

Third-grade societies are formed by co-operative wholesale societies or co-operative unions with or without the participation of local co-operative insurance societies. (12)

Co-operative Labour Insurance Institutions

Such institutions can be organised as a self-help association of workers to look after and support the dependents of its deceased members. The co-operative mutual-aid societies for insurance can be formed on sound scientific basis and operated very successfully in a competitive market. Such societies can be formed jointly by consumers co-operative insurance societies and the trade union organisations. (13)

Agricultural Co-operative Insurance Societies

Rural insurance based on mutual aid principles has been in vogue in various countries long before the advent of modern scientific insurance. (14) Agricultural insurance has its peculiar characteristics which are to be found in the nature of the risks involved in this industry, e.g. risks of hail, livestock, crops, forest-fires, windstorm, floods and other weather hazards, etc. All these risks lack any aid of reliable actuarial tables and also sometimes lack adequate

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12. Barou, op.cit.,p.128.
13. Barou, op. cit., p.166.

statistical data.

Agricultural insurance is affected by two special factors. Firstly, it has to deal with policy-holders who are scattered all over the land. Secondly, there is difficulty of close supervision of the policy-holders and the insured objects. In other words, the moral hazard is of great importance in mutual insurance.

Agricultural insurance societies may be formed by individual members as in the U.K. and Australia, or have the State-aided national system of mutual insurance as in France and Italy. The French system of mutual insurance organisation has many salient features. Legally only the mutual societies are allowed to practice non-profit making insurance. The surplus can in no case be divided among the members of the insurance society.

Co-operative Employers Insurance Societies

In countries where employees are not protected by state-insurance they have formed their own co-operative insurance societies to safeguard their various interests. Employees of any trade, industry or profession can form a co-operative employers insurance society to protect the interests of their own members .

The Functioning of Co-operative Insurance Societies

Co-operative insurance societies can be profitable or non-profitable. In the case of profitable insurance societies, a certain percentage of the annual or bi-annual profit is distributed among the shareholders who are also normally the policy-holders of the societies. But in the case of non-profitable, co-operative insurance societies, the whole profit goes to the common fund of the societies and nothing is distributed among the shareholders.

The common fund of the societies constantly grows due to the inflow of profits, especially in case of non-profitable societies. Even in the case of profitable societies, a sizeable portion or percentage of profits is reserved for the common fund for the benefit of the policy-holders.

Any group of workers, traders, or other people can form a co-operative insurance society or company and collect funds by contributions from its members. The instalments are collected from the members and the outlays are sanctioned. Anyone who contributes to the common fund, benefits from it when he is afflicted with a calamity. The funds are invested in profitable enterprises which greatly help in building up the capital of the societies. The members themselves or their elected officers manage and control the affairs of the society.

This type of co-operative insurance can take many forms and falls completely in line with Islamic principle of mutuality and co-operation because it realises the interests of the people. Commercial insurance will not be needed in a fully functioning Islamic society with its State Social Security system in operation and supplemented by co-operative and mutual insurance organisations. Most of the problems facing Muslims today would not exist in co-operative insurance. Many of the problems would be easily met by the State Social Security system without any difficulty. Very few of the remaining, unsolved problems would present no difficulty and would be effectively solved by the co-operative and mutual insurance organisations.

It is said that co-operative insurance is limited in its scope and means and is only preventive. But this is not an unremediable weakness for its scope and means can be widened by statutory measures. Besides, it applies to only one society and one trade. The co-operative insurance can be extended to cover all trades and professions and to provide cover against all sorts of hazards to its own members, each trade or profession having its own insurance society to meet their own losses. And indemnity contracts of commercial insurance companies can be very effectively replaced by co-operative insurance contracts with its members . In fact, all insurance business is a preventive measure against the probable peril or danger.

Thus, by organising co-operative insurance (side by side with mutual insurance) on a country basis and broadening its scope to cover all kinds of risks for its members, the multifarious insurance needs of the people can be fully and satisfactorily met. These societies can be easily organised and run by various groups of functional agricultural as well as industrial workers.

The multiplicity of co-operative assurance societies of various types all over the country will greatly increase the overall power, scope and resources of the organisation and enable it to meet quite effectively and adequately the insurance needs of the people. With better organisation and management, co-operative insurance can really become a great asset to society.

For greater efficiency and success in the field of insurance, the management may be forbidden by law from dividing profits among the shareholders, and a percentage of such profits may be restricted or reduced. Besides this, a permanent reserve fund may be maintained out of the annual profits for the purposes of meeting emergencies.

Also to keep the co-operative insurance organisation within the Laws of *Shariah*, the management would be forbidden from investing its funds in fixed-earning (i.e., interest) investments or indulging in any business activities containing any unlawful element of the nature of gambling *(maisir)*, risk, probability *(garar)* or uncertainty *(juhala)*.

The Benefits of Co-operative Insurance

A co-operative insurance society is very easy to form and run with the co-operation of all its members who are active workers as well as policy-holders. It has great many advantages for the people as shown below:

1. It realises the interests of the people and brings solidarity among their rank and file.

2. It is not run on the basis of profit-making, but in certain cases of surplus, profit may be shared by the policy-holders.

3. There is no profiteering, exploitation or fraud, partly because the policy-holders make up the administrative body and partly because the common fund and general operation of the insurance society are strictly under the control and supervision of the Government. The Law protects and safeguards the interests and rights of the members.

4. Funds can be invested in profitable enterprises, thereby increasing the

common fund of its society for the benefit of all members.

5. Its surplus belongs to the members who are the policy-holders and not the shareholders as in the case of commercial insurance company.

6. Its terms of contributions as well as compensation are generous and reasonable to the members partly because profit-making is not its motive, and partly because the members are on the governing body of the society.

7. There are few, if any, false claims of compensation because those who receive help on the occurrence of a peril have themselves contributed towards the common fund and have also control over the management of the society.

8. Risk is shared by all the members of a co-operative insurance society. Thus individual risk is transferred into a collective one. Individual loss is spread over a large number of people, in this case, over all the members of the society. In this way, the whole group bears the burden of loss of one of its members through co-operative and mutual aid.

9. The benefits of co-operative insurance societies go far beyond the commercial insurance companies because these are working for the welfare of their members and not for profit-making.

10. Furthermore, it reduces the cost of the operation and the number of lapses and risk probability, offers fair and just treatment to the policy-holders, it increases safety, and raises the moral standard of its members through development of the co-operative spirit and sense of responsibility and mutual aid.

11. It is also of great significance in the sphere of the moral attitudes of the people. All the members live together, work together, know each other and fully realise that the loss in peril will be taken out of their own pockets, especially in the rural areas. This realisation on the part of the members will develop in them a high sense of duty and responsibility with regard to the interests and needs of their fellow members.

12. It will eliminate altogether the intermediary agents and with it all the evils of the agency system in selling policies for profit-making.

13 . In addition to material benefits, co-operative insurance has great educational and organising value. It helps them to establish a network of social institutions for the welfare of the members.

وَمَا مِنْ دَآبَّةٍ فِي الْاَرْضِ اِلَّا عَلَى اللّٰهِ رِزْقُهَا

SECTION FOUR

ISLAMIC SOCIAL SECURITY

it also forfeits its right to demand obedience to its laws by the people. Such a State is no longer the real representative of the people. However , if it lacks the funds and resources to achieve its objective, then it must find out ways and means to make such resources available to meet the existing situation.

Meaning of Social Security

Social security provides a decent standard of living, including food, clothing, shelter, medical and educational facilities, etc., to every citizen of the State. This is not a static provision but one which changes in time and, perhaps, place. It is the duty of the State to provide the necessities of life to every individual according to the prevalent custom, usage and common norms. It does not, however, mean that the State has to provide all these things to all its citizens. In actual practice, it is only the low-paid, and non-earning members of the community who need State help in one form or another.

Harry Calvert has defined the Social Security Law in these words. "Those legal mechanisms primarily concerned to ensure the provision for the individual of a cash income adequate, when taken along with the benefits in kind provided by other social services, to ensure for him a culturally acceptable minimum standard of living when the normal means of doing so fail."

*Islamic philosophy is not confined to any one time or place. Islam gives us an everlasting philosophy of life which oversteps the boundaries of time and space and is applicable to mankind and its problems for all time to come. The social security system of Islam is based on the principles, first, that all wealth and property belongs to **Allah** and the State,as vicegerent of **Allah**, holds it as a Trust from **Allah**; and second,that the State guarantee of social security for all its citizens is on condition of people's obedience to the State laws.*

*There are many verses in the Holy **Qur'an** which show that all wealth and property belongs to **Allah** and the community is holding it as a trust from Him.*

1. *"And give them out of the wealth which **Allah** has given to you. (Q:24:33)*
2. *"To **Allah** belongs the kingdom of the heavens and the earth."(Q:57:5)*
3. *"Believe in **Allah** and His Messenger, and spend in charity out of the wealth*

whereof He has made you heirs." (Q:57:7).

*Those verses of the Holy **Qur'an** show that all wealth and property belongs to Allah and man is holding it merely as a representative or trustee of **Allah**. He exercises control over his wealth merely in his capacity as a trustee and not by his absolute right of ownership. He uses it and gives it to others not out of his, but Allah's wealth, as a trustee and not as an owner.*

*There are many verses of the Holy **Qur'an** which confirm this view that the owner of property is entitled to benefit from it so long as he acts in a manner conductive to the general good of society. But when he proves his inability to use it properly, he forfeits his right to use, transfer or own that property and the community is fully justified in withdrawing the right to use or own that property from that individual. This principle is referred to in the following verse of the Holy Qur'an.(4:5)*

*"And make not over your property, which **Allah** has made a means of support for you, to the weak of understanding. But feed and clothe them therewith, and speak to them words of kindness and justice. Make trial of orphans until they reach the age of maturity; then if you find sound judgment in them release their property to them."*

Though the wording applies to orphans, the principle stated is perfectly general. "Property has not only its rights but also its responsibilities. The owner may not do just what he likes absolutely. His right is limited by the good of the community of which he is a member, and if he is incapable of understanding it, his control should be removed, but gently and with kindness.

While his incapacity remains, the duties and responsibilities devolve on his guardian even more strictly than in the case of the original owner, for he may not take any of the profits for himself unless he is poor, and in that case his remunerations for his trouble must be on a scale that is no more than just and reasonable." (1)

1.A.Yusuf Ali, ***The Holy Qur'an***,1968,Footnote, p.179

Some jurists are of the opinion that even if a person has attained maturity of intellect (رُشد), but is wasting his wealth extravagantly, then, along with his own financial and moral loss, he is damaging the interest and good of the community as well; in fact, he has attained maturity, but is still at the point of 'weak understanding' (سفاهة), otherwise he would not have wasted his wealth and endangered the greater good of society. Such a man, who does not understand his own good, cannot really be called an intelligent and mature person.

Thus, whenever there is any possibility of the misuse of property, owing to the lack of maturity of intellect on the part of the owner, or the likelihood of danger to the common good of society, the individual's right of ownership or use can be forfeited or limited. The right to property or benefit is subject to its reasonable and proper use by the owner; if he does not fulfil his obligation or show his sense of responsibility in the use of his wealth, he forfeits his right to own it or benefit from it independently. This line of action is supported by the fact that the community inherits the property of those who die without any heir or heirs; they were given the custody of the property but when they died without any heir or heirs the property automatically reverted to the original and real owner, i.e., the Islamic State as vicegerents of *Allah*.

It can also be deduced from many verses of the *Holy Qur'an* and the *Sunnah* of the Holy Prophet that guarantee of social security for all members of the state is a pre-condition of their obedience to the State Laws. The State can demand obedience to its laws from its members only if it guarantees social security to them against hunger, sickness, unemployment, etc. It has absolutely no right to demand obedience from the people if it leaves them hungry, shelterless, sick and unemployed. The Holy *Qur'an* confirms this view in these words: "Praise be to *Allah*, the Cherisher and Sustainer of the Worlds; most Gracious, most Merciful— Thee do we obey, and Thy help do we seek (2:5)".

In the opening *Surah* of the Holy *Qur'an* ,*Allah* mentions His attributes of Mercy, Grace and Care for all the world. He has created all the world and He sustains it, maintains it and meets all its needs, from the moment of creation to the moment of death. After reminding the people of His gracious Favours upon them, *Allah* commands them to obey Him. Thus even the Creator of the universe has demanded obedience from His servants only after providing

immense favours and unlimited benefits to them.

The lordship and ultimate sovereignty belongs to *Allah* is further explained in the following verse of the *Qur'an:* "Sovereignty belongs to none but *Allah*. He has commanded that you shall not worship (or obey) anyone but Him. This is the right and straight Way, but most people do not know this (12:40)".

Thus, "the real owner of everything is the Supreme *Allah* Whom you also acknowledge as the Creator and the Lord of the whole universe. He has sent no authority and given no sanction to anyone for God-head and worship, but has reserved all the powers, all the rights and all the authorities for Himself, and commanded, "Serve and worship none but Me." In fact, *Allah* is the Lord of the universe who provides sustenance and all the needs to His creatures; and He is the Soveriegn who demands obedience to Him from all His creatures.

And again in *Surah Al-An'am* : "Then all are brought back to *Allah*, their real Master. Because of it that the sole authority of passing judgement rests with Him alone and He is the swiftest at reckoning." "Say, Who rescues you from perils in the darkness of the land and of the sea? Who is He Whom you implore humbly and invoke secretly (at the time of affliction?) To whom do you make promise. We will be gratefull if you rescue us from this affliction?" "Say, *Allah* delivers you from that and every other affliction. Yet you associate other partners with Him (6:62-63)".

That is, "you yourselves are a witness to the fact that *Allah* is All-Powerful; He alone has the sole authority and your prosperity and adversity wholly lies in His power and He alone is the maker of your destiny. That is why you turn to Him in your affliction, when you find that no other means of rescue has been left for you. In the face of this clear Sign, you have set up, without any reason, others as partners in His God-head, you live on His provisions but treat others as your providers: you get help from Him in your need, but set up others as your helpers and protectors. It is He Who rescues you from your distress, yet you regard others besides Him as your rescuers. It is He Whom you humbly invoke in your afflictions yet you take your offerings to others when He removes it. In short, you witness the proofs of His God-head, day and night, and still you serve and bow down before others." (2)

It is pointer to the fact that an Islamic state must provide the basic needs of its people. As vicegerent of Allah, it must , under all circumstances, guarantee and meet all the necessities of life of the needy members of the state. In other words, it is a legal duty of the Islamic state to guarantee social security to all its citizens.

This view is also supported by the action of the Holy Prophet who said that he inherited the property as well as debts of those Muslims who died without leaving behind any heirs. "Miqdam said, the Messenger of Allah said,"I am nearer to every believer than his own self; so whoever leaves behind a debt or children to support, it shall be our charge; and whoever leaves property, it is for his heirs, and I am the heir of the person who has no heir – I inherit his property and pay his debt."(6)

Obviously, the Holy Prophet inherited the property and debt of deceased Muslims without any heir, as head of the Muslim state. As such, after the Holy Prophet, a Muslim state (i.e. the community) would take the place of the Holy Prophet and inherit from the deceased who has left behind no heirs.

It is also reported from Abu Hurairah that the Messenger of Allah said,"I am, according to the Book of Allah, nearest to the believers of all human beings. So whoever amongst you dies in debt or leaves behind destitute children, you should call me for help, for I am his guardian. And who amongst you leave property, that is for his inheritor, whoever he is."(3)

"This ***hadith*** also gives a clear indication of the responsibilities of an Islamic state in regard to the destitute people. It is the duty of the Islamic state to look to their economic needs and see that they do not suffer from hunger and privation, to clear off their debts if they are not solvent enough to pay them back, and to properly look after the destitute families in case their earning members die. The Islamic state does not leave such helpless people to the stroke of fortune. The Islamic state has certain responsibilities with regard to them which it must undertake with full enthusiasm."(3)

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2. *The meaning of the Qur'an,* p.120
3. *Sahih Muslim,* Vol. III, English translation by Abdul Hameed Siddiqui, pp.855–56

The Islamic state endeavours to solve this problem in two ways, firstly, by organising welfare activities on a national level in the form of social security to help people in distress due to multifarious reasons beyond their control, secondly, by encouraging people to organise voluntary help and assistance for each other wherever possible.

1. The Social Security System

Every individual has the right to livelihood in an Islamic state, and every citizen has the guarantee for his basic needs. It is, in fact, the primary duty and responsibility of the Islamic state to see that every citizen gets his basic needs according to the principle of 'right to livelihood'. And there is complete equality among its citizens as far as the basic needs are concerned. According to this principle of the Islamic state, its social security department guarantees the basic needs to all those who are sick, old, needy, poor, unemployed or invalids and are unable to work.

This policy was followed by the Holy Prophet who provided financial aid to the needy and the poor from the public treasury, employment to those who were able to work and monetary help to those who were sick, invalid and unable to work.

After the Holy Messenger, Abu Bakr, his Caliph strictly adhered to the policy of public maintenance initiated by him. Umar, the second caliph, further expanded and developed the Department of Public Maintenance. He gave grants from the public treasury to all the poor and the needy, irrespective of their colour or creed. All people, Muslims, Jews and Christians, benefitted from his social security allowances. He gave child allowances, unemployment and old age grants and helped the poor, the needy, the sick and the invalids with various types of grants to meet their financial needs.(3)

After Umar, the Department of Social Security was well maintained by Othman, the third caliph and Ali, the fourth caliph, who provided help to all the needy and deserving citizens of the state. The system of public maintenance slackened in later years but was organised during the caliphate of Umar bin Abdul Aziz when the poor and needy were well provided with food

and other necessaries of life from the public treasury.(4)

The fact that the state was responsible for the basic needs of its citizens was fully realised by the establishment of the welfare state in Medina by the Holy Prophet. In the payment of these allaowances, he did not distinguish between a Muslim and a non-Muslim; all citizens of the Islamic state equally benefitted from these facilities. Every citizen who became an invalid , or was sick or was too old to earn his living , received financial assistance from the treasury.

A general rule was made during the caliphate of Abu Bakr, the first caliph of the Holy Prophet, which contained the following terms. "I have granted them the right that when a person becomes unfit to work because of old age or is struck by a calamity or any peril or misfortune and becomes poor, he will be exempted from ***jiziyah*** (or any other tax) and he and his family will receive maintenance allowance from the public treasury so long as he remains in the Islamic state. But if he leaves the country, the Islamic state will not be responsible for the maintenance of his family."

"The same rule continued in the reign of Umar, the second caliph, who strengthened it further by basing it on a verse of the *Holy Qur'an*. He wrote to his treasury officer that 'the poor' meant the poor among the Jews and Christians (because those were the only non-Muslims living in the Islamic state) in the Qur'anic verse 'charities were for the poor and the needy'. It is also related about Umar that once he saw an old man begging and he asked him why was he doing so. The old man replied that he was begging in order to pay ***jiziyah*** to the state. Umar took him home, gave him some cash and sent him to the treasury officer with an order that such old people who could not earn their living should not be forced to pay ***jiziyah*** but should be supported from the public treasury; and referring to the above verse of the *Qur'an*, added,"By Allah; it is not just that we should benefit from the people when they are young and turn them out to beg in the streets in their old age."(5)

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4. For details of Social Security System of Islam see section 9, and 11 in volume 1, pp.96–129 of this book.

5. ***Kitab Al Kharaj,*** p.85, quoted by Shibli Naumani, *Omar the Great,* English translation Vol. II, pp.173–174

Caliph Umar had completely understood the meaning of the verses of the Qur'an with regard to the needs of the poor and the destitute and the state responsibility, and he "desired that no one should go hungry throughout the Islamic state. He ordered that all cripples, paralytics and others who were too ill or too old to earn their living should have maintenance allowances from the public treasury. There were hundreds of thousands of men who had their names on the army register and the maintenance allowances were paid to their families."

The poor were given maintenance allowance from the treasury without any distinction of religion. Guest-houses were built in most of the cities to provide free meals to the travellers. Arrangements were also made for the proper care of children whom their mothers had left on the roadside; their nursing and other expenses were paid from the treasury. The expenses were fixed at one hundred *'dirham'* a year per head in the beginning and were increased year by year as the child grew."

"Arrangements were made for the proper maintenance and care of the orphans. During a famine, all the cash and food stores in the public treasury at Medinah were spent for the relief of the sufferers. When these did not suffice, the caliph directed the provincial governors to collect foodgrains from their territories and send them to Arabia, the famine stricken area."(6)

This policy was strictly followed by the successors of Umar. "It is reported about Umar bin Abdul Aziz that his sole concern was to remedy injustice and to distribute wealth among the poor people. When he became caliph, he spent two months absorbed in his grief and sadness at the affliction that had befallen him with the acquisition of authority over the affairs of the people. Then he began to look into their affairs and to remedy injustice until his concern for the people was greater than his concern for himself and he continued in this way, until his time came."(7)

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6. Quoted by Shibli, op. cit., pp.219–229

7. Bernard Lewis, ***Islam,*** Vol. I, ***Politics and War,*** London, 1974,p.168–170

The feelings and actions of early caliphs are a clear evidence that they fully realised that social security was their responsibility, being heads of the state, and for which they would be answerable to Allah on the Day of Judgment. It is the moral and legal duty of a Muslim state to provide the needs of the subjects before it can enforce its laws on them. Unless it fulfills this legal right it has no moral or legal right to claim or command obedience to its laws from its subjects.

This responsibility of the state towards its subjects is summed up by Abu Yusuf in these words when he wrote to Harun-al-Rashid. "O commander of the faithful, Almighty Allah has guided you with a mighty task, whose reward is the greatest of rewards and whose punishment is the direst of punishments. He has girded you with authority over this community. Morning and evening, you build for a people and Allah has made you their shepherd, has entrusted them to you, has visited you with them and has given you authority over them. If the building is based on anything but piety, it will not be long before Allah strikes at the foundations and destroys it over him who built it, and sought aid in it. Do no squander the authority which Allah has given you over this community and flock, for power in action is by Allah's consent alone."

"Take care not to lose your flock, lest their master lay claim for them against you and make you lose your wages for your default. To your credit, you have only what you have done for the good of those whom Allah placed in your care; to your debit, what has harmed them. Do not forget to attend to those whom Allah has entrusted to you, and you yourself will not be forgotten. Do not neglect them and their affairs, and you will not be neglected."(8)

Social Security Scheme

The Islamic Social Security System is comprised of the following main areas to fianance the different needs of the people: (a) Non-Contributory Benefits and (b) Contributory Benefits.

(a) Non-Contributory Benefits

Non-Contributory benefits are mainly financed from *zakat* funds and other

revenues collected by the state. If there is genuine need, the Islamic state has the surplus – *al-Afw* – wealth from the rich people. It could be collected voluntarily on voluntary basis and could become a very important source of income of the state over a number of years for its non-contributory benefits.

The fund would also receive, in addition to ***zakat***, a regular flow of income from philanthropists and benevolent wealthy people who are always anxious and willing to contribute enormous sums of money to charitable projects for the pleasure of Allah. The state can conveniently organise this private source of income through proper channels and thereby augument its main reserves for the benefits under this category. It would need little effort on the part of the state to make people realise the importance and necessity of organising private charity on a national basis through the agency of the state. There would always be people who in spite of their poverty and need would not be willing to accept help from private individuals but feel no stigma or shame to receive various benefits from the state.

The standards do not remain static, especially in a progressive society, but change from time to time. The actual levels of these benefits will also be determined from time to time in accordance with cost of living prevailing at that time. In other words, there will be periods of review of the rates of these benefits to bring them in line with increases in the cost of living so that in time of inflation, they keep their original purchasing power.

As the subsistance levels are greatly influenced by the cultural needs of the people, rates of benefits would therefore take into account the cultural concepts prevailing at that time. It would also take into account the size of the family and the actual needs of the people.

Thus, the Islamic state would organise its social security system in a way that would guarantee a reasonable income required to maintain a decent standard of living above subsistance level. It would make every effort to provide the minimum but adequate necessities of life to every family in the state.

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8 Bernard Lewis, op. cit., pp.152–154

The main contributory benefits that an Islamic State would provide to its citizens under its Social Security system are summarised below:

(i) Family Allowances

The Islamic Social Security system recongnises the need for children's allowances, generally known as 'family allowances' on two grounds. Firstly, Islam encourages people to have large families and, therefore, provides an additional allowance for every child born in a family. Secondly, it makes extra provision for every child born in the form of additional allowance to enable their parents to maintain them without hardship or suffering to the family. All people, irrespective of their financial position, benefit rom this scheme.

(ii) Maintenance or Supplementary Allowance

There is provision in the Social Security system to provide a maintenance or supplementary allowance to those families with low incomes. If the income falls below a certain level, depending upon the number of children in the family, it is entitled to maintenance allowance. All those families who fulfil the qualifying conditions of a low income or find their income not sufficient to maintain their large families have the right to claim financial assistance from the State Social Security system under this scheme.

(iii) Invalid Allowance

It is the duty of the Islamic State to look after its invalid people who have been rendered incapable of work due to prolonged or chronic sickness or accident, or to other reasons. The Social Security system must make provision for such people so that they are not left uncared for and unattended. These people must be paid adequate benefits to maintain them and their families. The rightly-guided Caliph of the Holy Prophet made sufficient arrangements for such people and insured that they were paid adequate provisions for their maintenance.

If the invalid is unable to look after himself and needs constant care and attention, the Social Security Department should provide an attendant allowance for him.

(iv) Widows Allowances

The loss of a single bread-winner, the main source of income of a family, can cause untold damage to the interests of the family members. Therefore, it is absolutely necessary that urgent steps must be taken at the death of a family man so that the bereaved family does not suffer as a result of his death.

Islam has made the necessary provisions in its Social Security system to meet the needs of the family of the deceased person through a widow's allowance scheme. The widows get reasonable allowances sufficient to meet the needs of their children.

(v) Maternity Allowance

Child birth may often put extra burden beyond the normal capacity of some people, especially low-income families, and thus cause undue suffering and hardship to them. The process of child-bearing entails additional expense and puts a heavy burden on poor people who usually have large families. The Islamic State regards it a legal duty to help such families during periods of confinement by giving maternity allowances to the expectant mothers to enable them to cover their expenses of confinement and child-birth.

It may be pointed out that in all these cases, the actual amount of assistance will depend on each case. The individual has to file a claim with the Social Security Department and the amount of allowance or benefit will be assessed by the relevant authority in accordance with the rules of the Department. Each individual case will be judged on merits and the allowance or benefit paid to the applicants.

(vi) Old Age Pensions

This allowance is mainly for the benefit of the old people who have no other source of income in their old age. The Islamic State takes the responsibility of maintaining the old people by granting them old age pensions. It can be contributory as a professional pension of a teacher or civil servant in modern times or non-contributory– like the old age pension in an Islamic State. This

pension is usually paid out of the *Zakat* Fund but, if need arises, income can be obtained from other sources, e.e., the surplus wealth of the rich (العفو).

Under the contributory scheme, main reliance is placed on regular contributions from the working people. They contribute to the joint fund while they are employed and benefit from it when they are old and unable to work after the retirement age. This scheme is practically for all purposes and is a form of mutual insurance society. It may be organised on an industrial or national basis in which case the Islamic State can undertake it through its Social Security Department. Small contributions will be deducted weekly or monthly, as the case may be, from the wage-earnings or salaries of people, and formed into a Pension Fund. These funds will be invested by the State in profitable enterprises to earn profits for the benefit of the whole community. These pensions under the latter scheme will be paid to all the people who have worked during their youth, irrespective of their financial position, while the non-contributory pensions will be paid only to the poor and the destitute. The latter pensions will be paid out of the Pensions Fund accummulated over a period of time by individual contributions while the former will be paid solely out of the *Zakat* Fund.

(vii) Miscellaneous Grants

In addition to the above mentioned benefits, the Islamic State is also duty-bound to help other people who may be rich but are temporarily under financial strain and are unable to meet their needs. The Holy *Qur'an* refers to this legal obligation of the State in these words:– *"Sadaqat (i.e. Zakat)* is for the poor and the needy, and those employed to administer the Funds; for those whose hearts have been recently reconciled to Islam; for those in bondage and debt; in the cause of *Allah;* and for the traveller, thus it is ordained by *Allah,* and *Allah* is full of knowledge and wisdom (9:60)".

We have already explained above various benefits paid to the poor and the needy under different social security schemes.Here we will discuss other responsibilities of the Islamic State towards its people referred to in this verse of the Holy Qur'an.

(a) Feeding of Captives

Captives of war taken prisoners by the enemy must be fed even if their ransom in monetary terms has to be paid by the Muslim State. Ordinary offenders who have been imprisoned for petty crimes or as a result of civil suits should also be helped to win their freedom by paying their ransom money from the *Zakat* Fund.

(b) People in Debt

All those people whose liabilities of debt are more than their personal assets should also be helped out of the *Zakat* Fund to pay off their debt. However, it is imporatant to see that the debts, under no circumstances, were incurred for unlawful activities of the debtors e.g., by indulging in luxuries, drinking, gambling, etc. For this purpose, the debtors are classified in three categories. (9)

1. Those who incurred their debts to provide for the necessities of life to their families. As they are not wealthy and do not possess the means to pay their debts, their debts could be paid off out of the *Zakat* Fund.

2. Those who incurred their debts not account of their own families but in assisting other poor people. These people, whether rich or poor, must also be helped out of *Zakat* Fund to pay off their debts.

3. Those who incurred their debts on account of their indulgence in unlawful activities will not ordinarily be helped from the *Zakat* Fund to pay off their debts. However, in dire circumstances, when they become extremely destitute and their families reach almost starvation level, they could be provided funds for their maintenance, but not for paying off their debts.

"According to Imam Abu Yusuf, the debtors include all those people who are unable to pay off their debts. The author of Hedaya is of the opinon that it means those who owe debts and do not possess anything above the prescribed limit of Nisab. Qataba thinks that (غارمين) are those people who are entangled in the snare of debt and the burden of debt is due neither to their extravagance nor unlawful expenditure. And according to Mujahid (غارم)is one whose house is burned or whose belongings are washed away or destroyed

by flood (or any other calamity) and he cannot maintain his family."

"It is argued by our jurists that, among the beneficiaries of *zakat*, the *Qur'an* mentions debtors (غارمین) along with the poor *(faqir)* and the needy (مسکین), which shows that this item of expenditure refers to the wealthy debtors who have been forced by circumstances into debt because the poor debtors are obviously covered by the first two beneficiaries (i.e. the poor and the needy)" (10)

In all these and similar circumstances, it is the duty of the Islamic State to pay off the debts out of the ***Zakat*** Fund. The Holy Prophet and his rightly-guided Caliphs fully accepted the responsibility of paying off debts of the poor debtors as well as of the wealthy ones, who incurred their debts through accidents or calamities and were not spendthrift.

The following ***Hadith*** of the Holy Prophet supports this view. The Holy Prophet is reported to have said that, "Whoever leaves property is for his inheritors and whoever leaves any debt it is for us (i.e. the State.)".

In under-developed and agricultural countries, the farmers, due to the very nature of this industry, greatly depend upon the natural factors and are often heavily under debt. In most cases the farmers fall into debt through no fault of their own but for loss of crops or cattle due to natural calamities. The Islamic State could take the responsibility to pay off the debts of such people and lessen their burden so that they may be able to live and work in peace for their own good and for the general good of society.

4. Travellers (Wayfarers)

A person, who becomes destitute, but who cannot benefit from his wealth because he is away from home on a journey is called a wayfarer. He needs

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9. For details see ***Zakat*** chapter 14 -***Economic Doctrines of Islam*** Vol. 111 of the author.
10. Dr. Yusuf-ud-Din, op. cit. p. 732.

financial aid to enable him to complete his journey. He can be provided with financial help out of the ***Zakat*** Fund up to certain requirements during the journey provided his journey was not undertaken merely for pleasure or for holidaying.

According to Imam Abu Hanifa, a wayfarer who is in the middle of the journey will be given this aid but not the one who is at the start of the journey. But the words used are general and have very wide application. Any wayfarer who meets any calamity and loses all his funds and has a genuine and reasonable claim can be helped from the ***Zakat*** Fund.

5. Assistance to the Guarantors

When someone accepts security on behalf of a friend or stands guarantee for a neighbour for a debt due by him an d who fails to honour his promise, there could be many unforeseeable factors e.g. fire, floods, earthquake, lightning, etc., beyond anyone's control which might adversely affect that friend's or neighbour's financial position and render him unable to fulfil his promise.

The guarantor has done a good job in providing assistance to another person by obtaining postponement of the payment of his debt and he should not be left to suffer for this act of kindness. It is, therefore, a duty of the Islamic State to help people in all such cases to pay off their debt which they have to bear for doing an act of goodness.

These are briefly the non-contributory benefits which are provided by the Islamic State through its Social Security Department to its deserving members. All these benefits were actually paid by the rightly-guided Caliphs in various forms to the people. And no one, who had suffered any calamity through accident, poverty, unemployment or large family, was not left alone to bear the burden of his misfortunes but was assured financial help from the Central Treasury ***(Bait al-Mal)***. This national Security System organised by the Islamic State fully met the multifarious needs of its members and made life equally happy for all of its citizens.

This Social Security System could be organised on modern lines to make it more comprehensive and include many of the needs which ordinary individuals find it difficult or impossible to meet merely through their own efforts. A number of these needs, e.g., poor people's houses, farmers implements, crops, etc., burned by fire or destroyed by other calamities, could be fully met or subsidized from the *zakat Fund;* other needs could be met from contributory funds which will be explained in the following pages.

(b) Contributory Benefits

The Islamic State is also committed to provide aid to various semi-public and private institutions which are working for the welfare of the people and sometimes face financial hardship due to unforeseeable circumstances beyond their control. Such aid could be provided from the *zakat* fund or surplus Wealth (العفو) of the wealthy members of the State. Whenever circumstances demand, this aid could be given through the following three channels:

(i) Professional Pensions

Many public, semi-public and private institutions organise professional old age pensions schemes based on the contributions of their employees. Under these schemes, the employees are required to contribute weekly or monthly payments in the form of superannuation, graduated pension or national insurance from their wages or salaries, as the case may be and, in return, they are promised a professional old age pension at retirement, determined according to set rules of each department. These pensions are in addition to the National Old Age Pension which each citizen of an Islamic State will get when he reaches a certain age and is in need of financial assistance.

The funds collected in pension contributions by the various departments from their employees will, of course, be invested in profitable but safe enterprises and will grow manifold over a period of time. They will be able to pay reasonable pensions to their employees at retirement but if they are in genuine financial difficulties due to factors beyond their control, the Islamic State might provide them aid from the *zakat* or Surplus wealth Fund (العفو) to meet this abnormal situation. This aid could be given in the form of an interestfree loan returnable in easy instalments in reasonable time, or grant

without any strings to avoid any embarrassment to the retiring employees of that particular institution.

(ii) Mutual Insurance Societies

Hundreds of mutual insurance societies are organised by workers all over the country to provide them with assistance in case of hazard to their persons or properties. Workers of each industry can organise their own mutual insurance society to guarantee them help against injury or any other peril. The Islamic State will, however, contribute to their common fund whenever there is deficiency or need for state assistance either from the *zakat Fund* or surplus wealth of the rich (العفو). Similarly, co-operative insurance societies could also be helped by the Islamic State to tide over its difficult periods.

Zakat Fund and Insurance Needs

It is argued by the supporters of commercial insurance that if the *zakat Fund* is used for meeting the insurance needs of the people, it may fulfil great many needs of insurance but may be prejudicial to the interests and needs of the poor and the needy. Besides, many perils unknown before may occur and drain away all the funds of the *zakat* and thus may prove too heavy a burden on the *zakat Fund*. Furthermore, the insurance needs of the community in the modern age are so many that they cannot be met by the *zakat Fund* alone. It may meet some assential requirements and thereby supplement the vast requirements of the general insurance business.

But the supporters of commercial insurance forget that the *zakat* is not the only instrument for meeting insurance needs of the community but is one of the three most effective measures adopted to solve the insurance problems of the people. The Islamic State endeavours to provide guarantee against various hazards to its people, especially the poor and the needy on three fronts. In its triangular plan, the *zakat* occupies an important part of its social security scheme to meet the people's multifarious needs which are met by commercial insurance in the modern world.

In this triangular plan, the *zakat*, as a part of Social Security, can cover many cases of accidents, involving the poor, the needy, the destitute, the old and travellers. It can also cover cases of house, fire and car accidents involving those poor and needy people and can pay the required compensation to the injured party. Thus, almost all cases of hazards involving the poor and needy can be very effectively covered by the Social Security Department from its ***zakat Fund*** without being burdensome or prejudical to the interest of the deserving people.

The needs of wealthy people struck with various kinds of hazards can be very conveniently met from the Social Security Scheme in general which receives funds from different sources of the community, including the surplus wealth of the rich (العفو). In fact the *zakat* and the general Social Security Scheme are mainly used to supplement the work of thousands of mutual and co-operative insurance societies in the country.

Mutual insurance and co-operative insurance societies are organised by industrial workers and farm labourers to seek security against various kinds of perils on the basis of mutuality and co-operation. All the workers or members contribute to meet the loss of those members who are faced with any hazard. Countrywide organisations of these societies supplemented by the Social Security Scheme is quite adequate to safeguard the probable losses of the members of the community. And this triangular approach can very effectively meet all the insurance needs of modern times without involving any element of interest ***(riba)***, gambling ***(qimar)***, risk probability *(garar)* or uncertainty ***(juhala)*** in its operation.

The supporters of commercial insurance unduly exaggerate the multiplicity of the insurance needs of modern society and reject the *zakatFund* as an alternative to meet the insurance needs of the people. They point out that there are new demands, new pressures, and new needs beyond the scope of this fund.

But what they forget is that the Muslim society has always in the past very effectively and efficiently solved these problems without much difficulty and there is no reason why the new problems of modern times cannot be

reasonably tackled on the same principle but with improved and better techniques and methods.

There is no need to overburden the ***zakat Fund*** or the Social Security Scheme with modern increased requirments of society; each system organised by the Islamic state is quite adequate in conjunction with the others to meet the multifarious needs of the community at all levels. If our Social Security System is organised properly and mutual insurance and co-operative insurance societies are established on the principle of mutuality and co-operation all over the country, every legitimate demand of the people can be effectively met. However, if greed becomes rampant in society and people go for more and still more without any upper limit to their desires, then no amount of private or public insurance can help them. If women start insuring their legs, voices and face beauty and men seek similar insurance to match their better-halves then no insurance system can meet their needs.

The triangular system of insurance introduced by Islam since the early Caliphate is adequate enough to meet the reasonable and legitimate insurance demands of the people but not their greed. In fact, many of the insurance needs that are being adopted by the Muslims from the West will not arise in a properly organised and fully-functioning Muslim society.

مَآ اَفَآءَ اللّٰهُ عَلٰى رَسُوْلِهٖ مِنْ اَهْلِ الْقُرٰى فَلِلّٰهِ وَلِلرَّسُوْلِ
وَلِذِى الْقُرْبٰى وَالْيَتٰمٰى وَالْمَسٰكِيْنِ وَابْنِ السَّبِيْلِ كَيْ لَا يَكُوْنَ
دُوْلَةً بَيْنَ الْاَغْنِيَآءِ مِنْكُمْ ۗ وَ

SECTION FIVE

BANKING – INTRODUCTION

1

Introduction

Banking as a social institution has had its successes and failures. It has contributed greatly to the development and growth of modern industrial society; large scale production and capital formation on the magnitude involved would not have been possible without the financial assistance of the banks. Banks have performed an important role and have very successfully served the needs of society by channelising the savings of the people where they were needed. They have been in a position to offer the needed funds through bank credit to businessmen for investment purposes on the payment of interest. They have, in fact, played a dominant role in the distribution of the community's available financial resources among its various sectors although it has not always been in the best interest of the community at large.

As the main object of the banks is profit-making, they have always given preference to fixed-interest earnings and short-term, but high yield enterprises, irrespective of society's commercial or industrial needs. This policy has led to an unfair and unjust distribution of wealth and income, resulting in the concentration of economic power in fewer hands, thereby causing serious social, economic and moral problems.

The entrepreneur who takes a risk in investment, for example, has to bear the cost of fixed-intrest payment over and above his borrowed capital. His position is always vulnerable, especially when there is a low rate of profit, or no profit at all, from his investment. In spite of his hard work, managerial and enterprising skills, he may receive little or no profit from his investment, while the supplier of capital is assured of a fixed interest, no matter what the outcome of the business enterprise. It is extremely unjust to guarantee periodical, fixed-earning payments to the suppliers of capital while the extent of the entrepreneurs' reward, who are the ultimate producers of wealth,remain uncertain. The inequity is further aggravated when the enterpreneur faces a loss

a low profit, but has still to pay fixed interest on the borrowed funds to their supplier.

Furthermore many socially useful and beneficial economic projects with a low profit yield are often abandoned because of the difficulty of paying high interest on the borrowed capital. Sometimes because of their high interest rates even governments find it difficult to undertake such low profit yield projects, although otherwise, socially very beneficial, and they have to adopt other fiscal methods to raise funds for the purpose.

Banking undoubtedly performs useful and essential services to the community and no modern society can make much progress or even maintain its rate of growth in the industrial and technical sectors without it. On the other hand the whole credit system of modern banking is built upon the institution of interest, which has led to so many economic and social evils. Among other things, the institution of interest puts a check and brake on economic progress, especially in under-developed economies, where most of the new projects, though of high social priority, have often very low profit yielding capacities and, consequently, fail to warrant high interest rates. Such low profit yielding projects are either not undertaken at all, or if they are, they are left unfinished because of the high burden of interest payments. (1)

In addition, since the payment of interest is bound up with production costs, it tends to increase the price of goods and services, again to the deteriment of the poor in the under-developed countries who can least afford to pay high prices. Thus, interest tends to damage the welfare of the poor in two-days: it retards investment activities in socially beneficial, but low profit yield projects; and it leads to increased production costs causing a rise in the price of consumer goods. In an Islamic society it is therefore an essential priority to introduce fundamental reforms in its banking system in order to remove the system's existing deficiencies and bring it into line to meet the best interest of modern society. To do this it will be necessary to take it out of the rut of fixed-interest earnings and to put it on the road to participation in enterprise on the basis of profit sharing.

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1. For details see volume 111 of this book.

The study of history shows that great religious and other thinkers have in all ages condemned interest as a social evil. Even the well-known classical, neo-classical and modern economists are in agreement that the institution of interest is an obstacle in the development of low-profit yielding projects. Interest makes it very difficult, indeed impossible, for national and local governments, especially in the developing economies, to initiate or continue with new social welfare projects with low profit margins which would otherwise be of immeasurable value to the community.

Islam has performed a great service to humanity by explaining the economic, social and moral evils of this blood-sucking institution which tends to retard the growth of highly valuable and beneficial projects, merely because they have low profit margins. By prohibiting interest Islam has put an end, once and for all, to all the injustice and inequity in the economic sectors.

If it is to exist as an independant political body with an expanding economy, the Muslim world must then undertake a reappraisal of conditions in the whole economic sector. There is a need to revive our old institutions which have long since fallen into disuse and have ceased to have any purposeful meaning for the average Muslim. Because they are old these institutions are regarded with growing indifference by our intelligentsia who see them as ill-adopted and irrelevant to the needs of the modern industrial world – a saddening and regretable attitude. It is all the more disheartening and disapponinting that some of these institutions no longer even function in any part of the Muslim world.

The pessimistic regard in which these institutions are held is both unwarranted and fatal. It is true that interest-free banking has not been in operation anywhere in the world since the middle ages and the working knowledge of its principles and composition has been forgotten. It is true, though very painful, that we cannot show the Western world any interest-free bank now in operation anywhere in the Muslim world. And there is no doubt that this is in part due to the fact that the Muslim world has been under the influence of Western civilisation for over two centuries, during which time it adopted, among other things, the Western economic system based on interest. Now practically everywhere throughout the world Western banking practice has become a part and parcel of life and no one can even think of any economic system which lacks it.

Many Muslim scholars and economists, not to speak of non-Muslims, even doubt the feasibility and validity of Islamic banking and regard it as irrelevant to modern industrial society. This attitude on the part of some of our brothers is due in some measure to ignorance and apathy towards Islam and its institutions, and partly to the tremendous influence of Western civilisation and its scientific, industrial and technological progress.

It is, therefore, the duty of Muslim scholars and economists to adopt a positive approach to the practive of Islamic banking and to produce evidence showing not only feasibility and validity of this system to modern economists and bankers, but also demonstrating to them its relevance and necessity in the modern world. At the same time we should thoroughly study Western banking which has helped the society in which it was practised, to achieve rapid economic growth and try to analyse the basic factors that were at work.

We cannot adopt any system, however beneficial, if it is based on unlawful practices such as interest; Islam not only forbids it but also declares war on those who practice and maintain it in their system. The right approach, therefore, will be to study modern banking separating out the good things in the system and finding ways and means to benefit from it without involving interest. We can adopt such useful and good things like the organisational, managerial and structural side of banking while leaving the evils of the system, like the unsocial and harmful practices of interest, speculative dealings and profiteering to others.

People have now grown accustomed to Western banking and have full confidence and trust in its viability as a great institution. It is desirable and necessary that some preparatory work should be done to create a favourable climate for the successful launching and operation of an Islamic bank. No bank nor its policy can ever successfully operate in any country unless the people have full confidence and trust in its creditability. Even the currency notes issued by the central bank of a country and backed by its government are sometimes refused by the people through loss of confidence in the government.

In order to inspire public confidence in the creditability of the Islamic bank which is absolutely necessary for its success, every Muslim government should give its full support. At the same time all dealings involving interest in all its forms and all banking based on interest should be prohibited by law. If such dealings are not forbidden by law, or if the law is not strictly enforced, then the whole enterprise will have no possibility of achieving any tangible success. It must also be remembered that Islamic laws can produce fruitful and beneficial results only when they are all jointly operating in a Muslim society; half-hearted efforts to apply one or two of them will lead nowhere. The consequent failure of these efforts will further alienate the Muslim masses from the principles of Islam which are already under attack, and are being labelled as unpractical, out-of-date and irrelevant under modern conditions, by both Western writers and 'modern' Muslims.

It is therefore both desirable and necessary that along with the establishment of an Islamic bank, other Islamic laws concerning *zakat* inheritance, hoarding, social security, anti-social and harmful activities are also enforced to achieve the optimum results. The observance of one or two of them is not enough to solve the problem unless and until they become an integral part of the whole Islamic system.

At this stage one of our oldest and most popular business institutions, *Mudarabah,* needs to be revived and its original function reinstated. The establishment *of Mudarabah* banks in place of modern commercial banks can very effectively solve many of our problems in this area. These banks will bring the suppliers of capital into close contact and co-operation with the entrepreneurs. Thus, both participants, the principal and the investor, will actully be involved in the process of investment and production through the agency of *Mudarabah* banks and will share in the profits. This will help in eradicating the evils of modern banking and assist in the building up of a healthier, stronger and just society one in which all mal-practices of *Ribe* (interest), speculation, profiteering, blackmarketing, forward buying and selling will be prohibited. The financial sector will be maintained at a reasonable size in accordance with the actual commercial and industrial needs of the country.

Along with this the three-pronged operation of the Islamic laws relating to inheritance, *zakat* and interest will considerably reduce the concentration of

wealth and increase its circulation and encourage investment. It will discourage 'liquidity preference' habits in the community and at the same time keep the volume of consumer credit within reasonable limits. (2) The rate of profit which is actually realised and shared between the participants in the two-tier system of *Mudarabah* banking is both a reasonable and adequate substitute for the rate of interest received by the supplier of capital in the modern banking sytem and an equitable one for the investor.

It is our considered opinion that the abolition of interest and the establishment of *Mudarabah* banks will not in any way decrease the propensity to save because savings, as Keynes has argued, are a function of income and earnings making interest only a minor motive for saving. In the absence of interest, the possibility of making profits on the basis of participation with *Mudarabah* banks or by buying government-owned industrial shares, will serve the same purpose. Furthermore, the major portion of savings in modern industrial countries comes from institutional sources, irrespective of interest rate and not from individuals. Above all, there will not be any very great need for liquid assets in an Islamic economy both because gambling houses, casinos and other pernicious unlawful things which create its demand will be prohibited, and because of the general satisfaction and peace of mind people will experience as a result of the Islamic reforms.

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2. For details see Consumer Credit in the Chapter on short-term loans in this book

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2

1. Historical Development

The first bankers were the goldsmiths. Merchants and other people deposited their cash and valuables with the goldsmiths for safe custody, because few other people had facilities for the safekeeping of valuables. The goldsmiths issued receipts to the depositors to acknowledge that they had received the cash and the valuables. These receipts gradually began to be used to make payments to other merchants. " As this practice developed it became customary for the goldsmiths to issue receipts for convenient denominations instead of a single receipt for a large sum. In the course of time these receipts became bank notes, the issuer stating on them his promise to pay any bearer on demand an equivalent amount in cash. The more highly respected the banker among the commercial community the more widely would his notes circulate and less likely would holders wish to exchange them for cash." (1) " Modern banking of this type is said to have originated during the parliamentary years of the 17th century. During that troubled period, people had recourse to the goldsmiths as depositories for their money and valuables. In the more settled times which followed, the depositors still found it convenient to keep their money with the goldsmiths who were prepared to allow them interest upon it, upon the terms that it should be returned as and when required. The goldsmiths were only too glad to receive it, for they had discovered that the number of demands for repayment at any one time was unlikely to amount to more than a fraction of the whole amount deposited with them, and that in the meanwhile it could be profitably used for making loans to needy monarchs and noblemen, or to finance ventures in commerce and industry." (2)

" As the banking side of their business expanded and prospered some of them relinquished their activity as goldsmiths and became full-time professional bankers. The practice of banking, however, developed only slowly at first, and

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1. Hanson, J.L., ***Monetary Theory and Practice***, London.1962,pp.6,28–29.
2. Lord Chorley, ***Law of Banking, London,1974***. pp.18–19.

for a long time there were few bankers to be found outside London. It was the great industrial expansion of the second half of the eighteenth century that provided the stimulus to the growth of banking outside the capital." (3)

The bank of England was established in 1694, and for over a century it was the only joint-stock bank in England. Then gradually there appeared large joint-stock banks with many branches scattered all over the country. They are now commonly known as the commercial banks in England and as credit banks in Western Europe.

2. The Functions of Banks

The commercial banks accept deposits, make loans and clear cheques, transfer bank deposits from one person or firm to another and provide a variety of services to their customers, including the transaction of foreign exchange business, the purchase or sale of stock exchange securities on their behalf, and acting as executors or trustees. They also provide loan facilities to their customers in the form of credit cards and overdrafts. The credit card scheme is intended for the use of housewives and other shoppers and businessmen. For large business customers, overdraft facilities are very useful and usually re-negotiated at regular intervals. Under this arrangement, clients agree to a credit limit with the bank, and are able to draw cheques on their ordinary current accounts up to that limit. For all these services, the commercial banks charge interest or take commission for their services from their customers.

In short, the chief services of a commercial bank are to receive, transfer and encash deposits and to make loans to its clients. Its chief economic function is to enable the productive use of its money (deposits) in industry or in professional or private activity. It offers three principal types of banking account facilities; Current Account; Deposit Account (or Time Deposit Account); Saving Account, (on which it pays interest to its customers).

But commercial banks are forbidden to undertake any direct commercial enterprise, e.g., buying and selling commodities. They are, however, allowed to

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3. Hanson, J.L., pp.6,28–29.

buy and sell foreign currency, under certain restrictions, and also bills and promissory notes in terms of local currency. The main functions of the commercial banks, however, are to accept deposits and advance loans.

3. The Banking Structure

Every country has its own structure of banks and other financial institutions and within the frontiers of each country these institutions have grown bigger, with hundreds of branches. For instance, in England, the " Big Five " banks—Barclays, Midland, Lloyds, Westminster and National Provincial have almost six-sevenths of the entire banking business.

The financial systems of the Western world fall into three main categories: the Central Bank, the Commercial bank, and the financial institutions.

The main difference between a commercial bank and a central bank is that the former thinks primarily of making a profit, whereas the latter thinks of the effects of its operations on the working of the economy. A commercial bank has its shareholders and has to make the maximum possible profit for them. There may be hundreds of such banks in a country and they all do business with the general public. The central bank, on the other hand, is usually owned by the government of the country. There is only one central bank in each country and it has few offices and does very little business with the general public. Its main operations are directed and influenced by the national economic policy of its country.

Other financial institutions are the merchant banks, savings-banks, co-operative banks, industrial development banks and agricultural development banks.

4. The Banking Contract

In the United Kingdom and many of the Commonwealth countries, any number of persons from two to fifty may form a private company to carry on the business of banking; and similarly any number of persons, from seven upwards may form a public company for this purpose.

the same way, two but not more than ten persons may form a partnership to carry on the business of banking. A valid contract must contain the following elements: (4)

(a) Offer and acceptance;
(b) Intention to create contractual relations as a result of the agreement;
(c) Form or consideration;
(d) Capacities of the parties to contract;
(e) Reality of consent;
(f) Legality of object and
(g) Termination;

If any one or more of these component elements is absent the contract will be void and unenforceable.

(a) Offer and Acceptance

"There must be mutual assent by the parties to the terms of the contract, and this consists of a definite offer and proposal by one party and its unqualified acceptance by the other party." (5)

(b) Intention to Create Contractual Relations

"The parties to the offer and acceptance must intend that their relationship shall create legal obligations, i.e., they must intend their agreement to be a legally binding contract, enforceable in the courts." (5)

(c) Form or Consideration

Both forms and consideration are essential for a simple contract. " However, it is the element of exchange which is the root of every simple contract. In such a situation, where the act constituting the consideration is completely performed, the consideration is said to be ' executed ' " . (5)

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4. Reeday. T.G., *The Law Relating to Banking* , London, Butterworths, 1970, pp.3–4.
5. Reeday, op. cit.,pp.4–35.

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5. Reeday, op. cit.,pp.4–35.

(d) Capacity to Contract

" That the parties to a contract should have contractual capacity to enter into that contract is a self-evident requirement." (5)

(e) Reality of Consent

" There must be a genuine and complete agreement between the parties to the contract, and various factors may operate to prevent such true consent,e.g., fraud, misrepresentation, and duress and undue influence." (5)

(f) Legality of Object

" Clearly, no system of law will condone agreements between individuals that the law itself prohibits or regards as contrary to public policy. The various categories of illegal contracts include immoral contracst, which are centered round sexual immorality, and contract tending to injure the public service, to impede the administration of justice, or contrary to public policy." (5)

(g) Termination of Contract

Just as a contract is entered into by mutual agreement of the parties, it may likewise be terminated by mutual agreement, or in any of the following ways:

(a) Proper notice by one party to the other;
(b) Death of one of the parties;
(c) Mental illness of either party;
(d) Bankruptcy of either party.

5. Agency

" It is lawful for a person to appoint another his agent, for the settlement on his behalf of every contract which he might have lawfully concluded himself; because, as an individual is sometimes prevented from acting in his own person, in consequence of accidental circumstances, he is, therefore admitted, of necessity, to appoint another his agent, in order that that person may expedite his wants by means of the powers which he derives from such an appointment.

It is confirmed by the action of the Holy Prophet who appointed his own agents in many cases, including purchase, marriage, etc." (6)

It is very common in modern, highly-organised societies to delegate powers or tasks to other persons generally known as agents. The appointment of an agent can be made in writing or even orally in simple contracts. The task or authority delegated to an agent may be explicitly mentioned in the terms of his appointment, or may be implied by the circumstances of the case. (6)

(a) Duties and Rights of Agents

The duties and rights of an agent may be summarised as follows:-

(i) " The agent has a duty to carry out his appointed tasks with reasonable skill and diligence." (7)
(ii) " The agent must not delegate his authority. But there are certain exceptions to this general rule,e.g., " Where custom sanctions delegation; when delegation is necessary for proper performance; and when there is statutory, express or implied authority to delegate. When a client employs a solicitor, for example, there is implied authority to allow some of the work to be delegated to clerks." (7)
(iii) " The agent must not misuse or disclose confidential material and information acquired in the course of his agency." (7)
(iv) " The agent must act in good faith for the benefit of his principal, and must not make any secret profit or take any bribe, in the course of his agency." (7)
(v) The agent has a right to the remuneration agreed by the principal.
(vi) The agent is entitled to be indemnified against losses and liabilities properly incurred in the esecution of his agency.

(b) Validity of Agency

The validity of agency depends on two things. Firstly, that the agency must proceed from a competent constituent. The constituent must himself be legally

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6. Reeday, op. cit., p.376.
7. Reeday, T.G. op. cit., pp.62–73.

entitled to do the work for which he has appointed an agent, for, as the latter derives his authority from the former, it is necessary that the former should himself have that authority before he confers it on another. (8) Secondly, the agent must be of sound understanding, in such a degree as may enable him to know and execute the business for which he has been appointed. (8)

(c) Invalid Agency

An agency is invalid when the terms in which it is expressed leave a great degree of uncertainty about its subject. If the constituent, in the appointment of his agent, should use a word applicable to a variety of general kinds of object, such as "animal", or a word which seems to express a variety of meanings, such as a "house", agency is invalid. This applies even though in making the appointment the constituent may have specified the price; for articles within either catagory may be purchased for the same price; and it is not known which are the specific ones the constituent wishes to purchase. Because of the great deal of uncertainty involved, the agency in this case becomes impracticable. The agency is likewise invalid if the word used is applicable to a variety of species unless the constituent specify the price or define the species, though he should not mention the goodness or badness of the quality. (8)

(d) Types of Agents

Agents may be classified into three main groups:–

(i) General

A general agent is one who is given authority in absolute terms to do anything within certain limits by and on behalf of an individual or firm and his acts are binding on his constituent (i.e. principal). For example, if a person says to someone "Buy whatever you think advisable on my behalf", it is not necessary for the constituent to particularise any further because, in this instance, he charges the agent with a discretionary care of his interest; and whatever the agent may then purchase will be considered as being in compliance with his order.

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8. Hedaya, op. cit., pp. 378-80.

(ii) Universal

The universal agent is one who is given unlimited authority to act on behalf of the principal in any capacity. (8)

(iii) Special

A special agent is one who is given authority to do a particular job or work on a particular occasion, or for a specific purpose. (9) An example would be when a person appoints another to purchase something of a particular quality, weight and price, or to do some specified work for him. (9) The agency ends with the completion of that particular assignment.

(e) What an Agent cannot do

An agent cannot purchase for himself any specific article which he is directed to purchase for his constituent. If a person appoints another his agent to buy him some particular article,the agent cannot purchase the article for himself, because this would be a breach of the trust reposed in him by his constituent. (10)

(f) Agency with relation to Banking

There are three important aspects of this relationship:–

(a) Agency and Bills of Exchange

Bills of Exchange may be signed by the agent on behalf of his client as when a partner in a firm signs on the firm's behalf.

(b) Borrowing of Money

"The principal will be liable to pay to the bank any amount of money borrowed by his agent without or in excess of his authority. The bank acting in good faith has an equitable right to recover against the principal to the extent to which the money borrowed has applied in paying the legal debts of the principal." (11).

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9. Reeday, op. cit., p. 55.
10. Hedaya, op. cit., p. 382.
11. Holden, J. Milnes, Vol. 1. Toronto, 1970 pp. 29-36.

(c) Cheques

"The principal is liable to pay for the cheques drawn by his agent, without authority of the bank, to pay the principal's debt." (11).

6. Banker and Customer in the United Kingdom

The terms of the contract between the banker and customer in the United Kingdom are not embodied in any written agreement executed by the parties. The contractual relationship which exists between the two parties is based upon the customs and usages of bankers, many of which have been recognised by the courts. (12).

The banker acts as an agent by performing certain duties for his customers; e.g. when he accepts their instructions to purchase and sell stocks and shares, or to transfer funds. The banker has an obligation to honour the customer's cheques provided (a) he has sufficient funds to his credit, (b) if not, that the cheques are within the agreed limits of an overdraft, and (c) that there are no legal restrictions to payment. (12) The banker must not disclose the state of the customer's account or his other business transaction, to anyone unless he is forced by law, or allowed by the customer, to do so. The contractual relationship between between the banker and customer may be terminated by mutual consent, or unilaterally, by either party.. (12)

7. Partnership

Partnership in the United Kingdom is governed by the partnership Act 1890 which defines it:"Partnership is relation which subsists between persons carrying on a business in common with a view of profit."

"Partnership is created by agreement, which may be oral, implied by conduct, written (i.e. Articles of partnership), or under seal (i.e. a formal Deed of partnership)".

A partnership may be for definite period of time, or to carry out a single venture.

"As regards the contractual capacity needed to be a partner, every one except alien, enemies and convicts may be a partner.

The Companies Act 1948 imposes a mamimum limit of ten partner in any

partnership carrying on the business of banking but Companies Act 1967 removes this limit for the business of banking and increases it to twenty partners." (13)

8. Types of Partners

There are four main types of partners under the provision of the Limited Partnership Act 1907:–

(a) "A general partner- who is personally liable for all debts and obligations of the firm and who takes part in its management. Hence, he is also called an active partner;

(b) "A dorment or sleeping partner - who contributes capital, shares in the profits and has personal liability for the firm's debts and obligations, but takes no part in the management;

(c) "A limited partner - whose liability is limited to the amount of capital he actually contributes and who cannot take part in the management of the firm. He takes a 'back seat' because of the statute, whereas a dormant or sleeping partner does so by inclination;

(d) "An incoming partner - who is admitted into an existing firm. He does not become liable to the creditors of the firm for anything done before he became a partner. He may, however, make himself so liable by special agreement." (13).

9. Relationship of Partners

The Act provides that every general partner is an agent of the firm and of his other partners for the purpose of the business of the partnership; and the acts of any partner within the usual course of the firms business bind the firm and his partners.

"A general or ordinary partner has the following implied powers:–

(a) To sell and buy goods for the purpose of the partnership business;

(b) To give discharges for money received from debtors;

(c) To engage servants for the partnership business;

(d) To draw cheques, unless this is not in the usual course of the partnership business."

In additional, in a commercial or trading partnership, a partner may bind the firm:–

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12. Reeday, op. cit., pp. 84-86.
13. Reeday, op. cit., pp. 87-89.

(i) "By contracting debts, and paying debts on its accounts, and drawing, making, signing, endorsing, accepting, transferring, negotiating, and discounting negotiable instruments;
(ii) By borrowing money on the credit of the firm;
(iii) By pledging partnership goods or securities for the purpose of its business.

Beside, additional powers may be given to any partner by express agreement."

A firm, and each of its members, is liable for the wrongful acts or omissions on the part of one of the partners acting in the ordinary course of the business of the firm, or with the authority of his co- partners." (14).

10. Liability to Third Parties

"Every partner in the firm is liable jointly with the other partners for all the debts and obligations of the firm incurred while he is a partner, and after his death his estate is also severally liable for such debts and obligations, subject to prior payment of his separate debts. Thus liabillity so far as contracts are concerned is joint; though by special agreement it may be made joint and several (or separate). With joint liability, each partner is liable jointly with all others and by himself, so the plaintiff can bring only one action, not several actions, against the members of the firm."

"If the creditor proceeds against the firm and gets judgement, he may issue execution against the property of the members, and where the joint property of the firm is not sufficient to satisfy his judgment, he can proceed against the separate or private property of each partner, for each is individually liable to his last penny for the whole of the debts and liabilities of the firm." (15).

11. Relation of Partners to Each Other

"Within the general framework of the law the partners may make what agreements they like between themselves; this is why, although a partnership

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14. Reeday, op. cit., pp. 90-92.
15. Reeday, op. cit.,pp. 92-93.

agreement may be verbal, it is preferable to reduce it to writing (either articles or a deed) so that all aspects of the partners' relations between themselves can be provided for, thus eliminating uncertainty, misunderstanding and disputes. The position of the partners generally, however, can be seen in two ways; (a) partnership property, and (b) partners' basic rights.

(a) Partnership Property

Partnership property is the property owned by the firm. It may have been originally brought into the partnership stock or acquired, whether by purchase or otherwise, on account of the firm, or for the purposes and in the course of the partnership business." (16).

(b) Partner's Basic Rights

In the absence of any special provisions, a partner enjoys the following basic rights as regards his co-partners:– (16).

(a) "He is entitled to the utmost fairness and good faith from his co-partners in all partnership matters .

(b) He is entitled to take part in the management of the partnership business; but is not entitled to any remuneration.

(c) He can prevent the introduction of a new partner with the consent of his co-partners.

(d) The nature of the partnership business cannot be changed without the unanimous consent of all the partners, though ordinary matters may be decided by a majority of the partners.

(e) The partnership books are to be kept at the principal place of business of the partnership, and every partner may, whenever he likes, have access to and inspect and copy any of them.

(f) He cannot be expelled by a majority of his co-partners unless a power to do so has been confirmed by express agreement between the partners.

(g) He is entitled to idemnity by the firm in respect of payments made and personal liabilities incurred by him in the ordinary and proper conduct of the business of the firm.

(h) In the absence of any special agreement, all the partners are entitled to share equally in the capital and profits of the business and must contribute equally towards the losses. Partners are joint owners of all property brought into, or acquired, by the firm, but on the death of any partner his interest in the property passes to his personal representative.

(i) He can assign either absolutely or by way of charge, his share in the assets and profits of the partnership, and the assignee has the right to receive, in whole or in part, the share of the profits." (17)

12. Dissolution of Partnership

The Limited Partnership Act provides that " subject to any agreement between the partners, a partnership is dissolved:-

(a) If entered into for a fixed term, by the expiry of that term;
(b) If entered into for a single adventure or undertaking, by the termination of that adventure or undertaking;
(c) If entered into for an undefined time, by any partner giving notice to the others of his intention to dissolve the partnership;
(d) By the death or bakruptcy of any partner, unless otherwise agreed;
(e) At the option of the other partners;
(f) The happening of any event which makes the partnership unlawful." (17)

In addition, " dissolution outside the court may arise from fraud making the original contract of partnership voidable at the option of the party deceived, or it may be that the partnership articles or deed make other circumstances a ground for dissolution. For example, the partnership agreement may make mental disorder, physical incapacity, incompatibility of temperament, or criminal conduct a ground for dissolution without the intervention of the court, which would otherwise be necessary.

Further, the court may decree a dissolution of the partnership in any of the following cases:—

(i) When any partner becomes permanently incapable of performing his part of the partnership contract;
(ii) When any partner has been guilty of conduct prejudicial to the firm's business;
(iii) When any partner wilfully or persistently breaks the partnership agreement so that it is no reasonably practicable for the other members to

16. Reeday, op. cit.,pp.92–93.
17. Reeday, op. cit., pp.96–99.

continue in partnership with him;
(iv) When the business of the partnership can only be carried on at a loss;
(v) Whenever the court considers it just and equitable to decree dissolution." (17)

13. Limited Partnerships

This special type of partnership was created by the Limited Partnership Act 1907, to allow some partners to enjoy the advantage of limited liability, as is done by members of a limited company. The main provisions of this act are:—
(a) " Such a partnership must not consist of more than ten persons in the case of a banking partnership.
(b) It must always include one or more general partners as well as one or more limited partners, i.e., there cannot be a partnership which consists solely of limited partners.
(c) A general partner is any partner who is not a limited partner, and is liable for all the debts and obligations of the firm.
(d) A limited partner is one who contributes on entering the partnership a stated amount of capital in cash or in property valued at a stated amount, and whose liability for the debts and obligations of the firm is limited to the amount contributed.
(e) If a limited partner withdraws directly or indirectly any part of the capital he has contributed, he is liable for the firm's debts and obligations up to the amount so withdrawn.
(f) A corporation may be a limited partner." (18)

14. Difference between a partnership and a company

The main difference between a partnership and a company are:—
(a) " The former is not a separate legal entity, whereas the later is. One consequence of this is that partnership property is jointly owned by the partners, but property owned by a company belongs solely to the company, and no member of the company in such capacity has any personal interest in it. Again, partners can conduct any business they agree upon, but the ***ultra vires*** doctrine restricts a company to the objects clause of its Memorandum of

18. Reeday, op. cit.,pp.107–11.

Association;
(b) The former does not have perpetual succession, whereas the latter has. Consequently, a partnership may be dissolved by various circumstances, but a company continues, despite changes in its members;
(c) The former has no common seal of its own as evidence of its formal acts, whereas the latter has.
(d) In partnership all the partners except the limited or special ones, have unlimited liability for the debts of the firm, whereas the liability of a member of a company is limited.
(e) In the former all the partners can participate in the management of the firm, but in the company the members cannot do so, except where they are also directors or senior executives of the company;
(f) In case of bankruptcy, the former is subject to the bankruptcy machinery, whereas the latter is wound up in the manner prescribed by the Companies Act 1948;
(g) Partnership affairs are private, whereas company's registers are available for inspection by the general public;
(h) There are difficulties for partners in partnership regarding the transfer of their interests but members of a company can easily dispose of their shares or stock at any time.
(i) A partnership cannot create a floating change over its assets, whereas a company can." (18)

15. A Company

(a) Nature

A company is a legal entity having a separate identity quite distinct from that of its shareholders and directors. It continues to exist when they have changed and can only be disolved by legally prescribed means. It has a distinctive name in which it can sue and be sued, and has a common seal.

(b) Formation

" Companies can be formed by compliace with the provisions of the Companies Act, 1948. Any seven or more persons, two in the case of a private company, associated for a lawful purpose may form an incorporated company in the manner prescribed by the Act. Three types of companies are possible:–

(i) A company having the liability of its members limited by the amount, if any, unpaid on their shares (known as a company limited by shares).
(ii) A company having the liability of its members limited by the amount that they have undertaken to contribute to the assets in a winding up (known as a company limited by guarantee). These companies may or may not have a share capital.
(iii) A company not having any limit on the liability of its members (known as an unlimited company).(18)

The memorandum of Association and the Articles of Association have both to be completed before a company can apply for registration.

(c) Memorandum:

The Memorandum of Association is the mainspring of the company. " It is a deed which states and defines the constitution and powers of the company, and any act beyond these powers is *'ultra vires'* the company and void."

The Memorandum must state:–
(i) The name of the company with the word " limited " added after it;
(ii) The registered office of the company and where it is situated;
(iii) The objects and purpose for which the company is formed;
(iv) That the members have limited liability;
(v) If the company has a share capital, a statement showing the amount of share capital and the value of each share, e.g., share capital of £1,000 divided into 200 ordinary shares of £5 each.

" The Memorandum must be singned by at least seven persons in the case of a public company, or by at least two persons in the case of a private company, and each signatory must have at least one share." (19)

(d) The Articles:

" The Articles of Association explain the internal rules and regulations as to

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(18) Reeday, op. cit., pp.112–123.

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18. Reeday, op. cit., pp.112–123.

the persons by whom and the manner in which the company's business is to be conducted. They show the practical day-to-day working of the company, fix the powers of the directors and the way they are to be exercised.

The capital of a company is subscribed by the members. The whole of the authorised capital may or may not actually be issued. The total issued capital is divided into shares which are offered for sale to the public." (19)

(e) Borrowing

A company normally raises loans from the public by issuing debentures, which are documents showing evidence of a loan. Normally they are of fixed amount and state the date of repayment and the rate of interest until that date.

(f) A Private Company

" A private company is one which by its Articles (a) restricts the right to transfer its shares; (b) limits the number of its members to fifty; and (c) prohibits any invitation to the public to subscribe for any share or debentures in the company. It can have minimum of two members and need have only one director, instead of the minimum of two necessary for a public company, and it need not hold a statutory meeting. A private company can be transformed into a public company and vice versa." (19)

(g) Operations

" A company can act through its directiors. The directors act collectively as a board, headed by a chairman. In some respects, directors are Trustees, and in other respects they are agents or managers of the company. Ultimately, the control of the company rests in the hands of its members through their votes at general meetings." (19)

(h) Capital

" The capital of a company is made up of funds subscribed by the members.

The whole of the authorised capital may or may not actually be issued; that which has been issued is called issued or subscribed capital. For instance, if a company has a capital of £50,000 in shares and has issued 8,000 shares, it may at any time issue all or any of the remaining 2,000 shares; once 10,000 shares have been issued, the capital must first be increased before the company can issue any more shares." Besides, " only part of the issued or subscribed capital may be actually paid up, i.e. the shares may be partly paid up, say £3 paid on £5 shares. In such a case the amount represented by the uncalled proportion of each share is known as the uncalled capital, and this may be called up by the company as and when required." (19)

(i) Winding up of a Company

Although a company has permanent existence and any change in its members does not affect it, it can be terminated by a method prescribed by the Companies Act, 1948 called liquidation or winding up. A company may be wound up by the Court when:—

(i) "The company has by special resolution so resolved,

(ii) Default is made in filling the statutory report or in holding the statutory meeting;

(iii) The company does not commence its business within a year from its incorporation or suspends its business for a whole year;

(iv) The number of memebers is reduced, in the case of a private company, below two, or, in the case of any other company, below seven;

(v) The court is of the opinion that it is just and equitable that the company be wound up."(20)

A company may be wound up voluntarily under the following conditions:—

(i) " When the period, if any, fixed for the duration of the company by the articles, or the event, if any occurs on the occurrence of which the articles provide that the company is to be dissolved, and the company in a general meeting has passed a resolution requiring the company to be wound up voluntarily.

(ii) If the company resolves by special resolution that the company be wound up voluntarily.

(iii) If the company resolves by extraordinary resolution to the effect that it cannot by reason of its liabilities continue its business, and that it is advisable

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20. Reeday, op. cit., pp.150-157.

to wind up. (20)

Within fourteen days from the date of voluntary winding up, the resolution must be advertised in the Gazette. Then the company ceases to do business. (20)

3

SHIRKAT (Partnership)

In this chapter we will examine the concept and the various provisions of *Shirkat* (Islamic Partnership) and compare it with British partnership law; the concept of *Mudarabah* (limited Partnership) and its various provisions will be looked at in the next.

1. Meaning of *Shirkat*

"*Shirkat*, in its primitive sense, signifies the conjunction of two or more estates, in such a manner that one of them is not distinguishable from the other. In the language of the law, it signifies the union of two or more persons in one concern. The term ***shirkat***, however, is extended to contracts, although there is no actual conjunction of estates, because a contract is the cause of such conjunction."(1)

Shirkat is lawful, because in the time of the Holy Prophet men were accustomed to have transactions in partnership a practise which he upheld. *Shirkat* is of two kinds: (a) ***Shirkat Milk***, or partnership by the right of property, and (b) ***Shirkat Akid***, or partnership by contract. (1)

(a) *Shirkat Milk* (Partnership by the right of Property)

"*Shirkat Milk* applies where two or more persons are proprietors of one thing. It is of two different natures, optional and compulsory. " Optional ***Shirkat*** is one where two persons make a joint purchase of one specific article; or where it is presented to them as a gift, and they accept it, or where it is left to them, jointly, by bequest, and they accept it; or where they both obtain possession of

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1. *The Hedaya*, translation by Hamilton , pp.217–31.

one specific article; or where they unite their respective properties in such a way that one is not distinguishable from the other (such as the mixture of wheat with wheat); or where it may be difficult to distinguish them (as in a mixture of wheat with barley)."

" Compulsory ***Shirkat*** is one where the properties of two persons become united without their act, under such circumstances as render it difficult or impossible to distinguish between them; or where two persons inherit one property. In this species of partnerships, therefore, it is not lawful for one partner to perform any act with respect to the other's share, without his permission, each being as a stranger with respect to the other's share. It is, however, lawful for either partner to sell his own share to the other partner, in all cases here stated; and he may also sell his share to others without his partner's consent, (excepting only in cases of association or a mixture of property, for in both these instances one partner cannot lawfully sell the share of the other to a third person without his partner's permission." (1)

(b) ***Shirkat Akid*** **(Partnership by Contract)**

Shirkat Akid is effected by proposal or consent. It is of four kinds:
(a) ***Shirkat Mufavada*** or Partnership by Reciprocity;
(b) ***Shirkat Ainan***, or Partnership in Traffic;
(c) ***Shirkat Sinnai***, or partnership in Arts; and
(d) ***Shirkat Woojooh***, or Partnership upon Personal Credit.

(a) Shirkat Mufavada **(Partnership by Reciprocity)**

" ***Shirkat Mufavada*** is formed when two men, being the equals of each other, in point of property, privileges, and religious persuasion, enter into a contract of co-partnership. In fact ***Mufavada*** means equality. This kind of partnership is a universal partnership in all transactions, where each partner reciprocally commits the business of the partnership to the other, without limitation or restriction." (1)

The main conditions of this partnership are:–

(i) Capital

there must be equality in capital of each partner. "It is , thererfore, indispensable that a perfect equality exists throughout, in the property, that is, in the partnership capital, such as ***dirhams*** and ***dinars*** (or in other words, in standard money)."

(ii) Privileges

In the same manner, it is essential that an equality exists in the privileges of the partners; because, if either partner were endowed with privileges not vested in the other, there could be no perfect equality.

(iii) Religious Views

Similarity of religious views is also required (for this will assist in the normal business of the partnership).

(iv) Reciprocity

The term "reciprocity" must also be expressed in the contract. This point is emphasised because the Holy Prophet has said,"Enter into partnership by reciprocity, for in that there is great advantage."(1) In fact, a contract of reciprocity is not complete unless reciprocity is expressly mentioned in it; the parties must declare "we are partners, in a partnership by reciprocity," because the conditions of it cannot otherwise be known. If, however, in entering into such a contract, they declare all the conditions of it, the contract is lawful, although the term reciprocity be not particularly expressed in it, because regard is given to the sense, and not to the letter.(1)

A contract of reciprocity can be made between two adults and comprehends both agency and bail. Its main provisions are:
(i) "This partnership cannot be contracted but in cash, (i.e. in standard money or in gold or silver coins). But Imam Malik thinks that such a partnership is lawful in goods and effects and also in all articles estimable by weight (or measurement of capacity), where the species is the same because a partnership so contracted respects a known and specified capital whence these articles are equivalent to money."(1)

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(ii) "A purchase made by either partner is participated between both the partners, except in articles of subsistence. Whatever is purchased by either of two partners under a contract of reciprocity is participated by both except the food and clothing, purchased by either of the partners for himself and his family; for a contract of reciprocity requires that both partners be upon a perfect equality; and as each is the other's susbstitute in all dealings, it follows that a purchase made by one is equivalent to a purchase by both. This, however, is exclusive of such articles as are here excepted."(1)

(iii) "A debt incurred by either partner is obligatory upon the other. Whatever debt is incurred by either of the partners in reciprocity , (for a thing in which partnership holds) the other partner is responsible for the same, in order that equality may be established."

(iv) "Bail for property, engaged in by either partner, is binding upon the other. If a partner in reciprocity becomes, in respect of a third party, surety for property to a stranger, it is binding upon the other partner likewise, according to Imam Abu Haneefa. The two disciples allege that it is not binding upon the other partner for a person's becoming surety for another is a gratuitous act." (1)

(v) *"If the bail is entered into without the consent of the partner, it is not binding upon him, according to Imam Abu Haneefa; because in a bail so contracted the property of mutual obligation or exchange does not exist in its continuance."*

(vi) *"This contract of partnership comprehends both agency and bail. It comprehends the property of agency, because if each of the contracting parties were not the agent of the other, the end, (namely), a mutual participation of property) would be defeated. It also comprehends the property of bail, because if each party were not surety for the other, the equality , in certain particulars essential to traffic (such as demand for payment from either of them for purchases made by the other), could not exist."*(1)

(b) **Shirkat Ainan (Partnership in Traffic)**

Shirkat Ainan is contracted by each party respectively becoming the agent of the other, but not his bail. This species of partnership is where two persons become partners in any particular traffic, such as in clothes, or wheat, or where two become partners in all manner of commerce respectively."

The main provisions of this partnership are:

(i) "It does not admit mutual bail, but it requires mutual agency. Bail is not a condition of this kind of partnership, but it is an indispensable requisite that each partner acts as agent on behalf of the other; since, without this, the design (namely partnership in property), cannot be obtained; as acts done on behalf of another are performed either in virtue of some avowed authority, or of agency; and no authority existing, agency is constituted in order that each may act for the other, so that property may be held in partnership between them."

(ii) "It admits of inequality with regard to stock. If the stock of one of the partners exceed that of the other, it is lawful, because there is no occasion for the equality as shall be (hereafter demonstrated) and the terms in which such a partnership is contracted do not require equality."(2)

(iii) "It also allows unequal profits. It is lawful in this kind of partnership that the stock of each partner be equal, and yet the profit unequally shared between the partners, that is, the profit to one partner exceed the profit to the other. Ziffer and Shafei maintain that this is not lawful; for if, with equality of stocks, an unequality of profits be admitted, it induces a profit upon property concerning which there is no responsibility because, if the capital appertains to the two in equal shares and the profit be divided into three lots (for instance), the sharer in the larger proportion of profit is entitled to a superior share without any responsibility, since the responsibility is in proportion to the capital; and also, because a partnership in the profit exists in virtue of partnership in the capital (according to their tenets, whence they likewise hold the admixture of the property to be a condition); the profit upon the property therefore, is the same as increase of living stock; and each is consequently entitled thereto, in proportion to his original right of property in the capital." (3)

"But the main arguments of Abu Haneefa are twofold. First, the Prophet has

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1. *The Hedaya*, op. cit., p.223
1. *The Hedaya*, op. cit., pp.223–30

said, "The profit between them is according to their agreement, and their loss in proportion to the property of each respectively", where no distinction is made between the equality or inequality of their property. Secondly, in the same manner, as a person is entitled to profit by virtue of property, he is also entitled to it by virtue of labour. It may also sometimes happen that one of the partners is more skilful and expert in business than the other, and consequently, that he will not agree to the other sharing equally in the profit, whence it is requisite that one have a larger share than the other." (3)

"Their reply to the objection of Ziffer and Shafei is that it resembles a contract of *Mudarabah*, and as such, each party manages with the stock of his partner; and it also resembles partnership by reciprocity, both with regard to its name (as being a partnership), and likewise with regard to the conduct of it, because both partners act in it. In consideration therefore, of its resemblance to *Mudarabah*, we determine that it is lawful to stipulate a profit upon property concerning which there is no responsibility and, in consideration of its resemblance to partnership by reciprocity, we determine that, if it be stipulated that both partners shall act alike (although a greater share of the profit be conditioned to one of the partners), yet the contract of partnership in actual stock is not invalidated." (3)

(iv) "It is lawful for either party, in partnership in traffic, to engage in the contract with respect to a part of his property only, and not the whole, because an equality in points of stocks is not essential to it, since the term *Ainan* does not require it."

(v) "A purchase made by one partner, where the stock of the other afterwards perishes, is participated in by both; and the partnership continues in force, agreeable to the contract."

(vi) This partnership does not admit a specification of profit on behalf of either partner. Such an action invalidates the contract, since it is possible that no more profit may be acquired altogether, than the sum so stipulated."

(vii) "Each partner hold the stock in the manner of a trust." (3)

(viii) "Each of the partners is at liberty to give his stock in the manner of an agency; because it is customary so to do in contracts of partnership; and also, because either partner is at liberty to hire any person to work for the acquisition of profit." (3)

(ix) In the same way, also, either of them is at liberty to lodge this capital as a deposit, as this is customary and sometimes necessary among merchants.

(x) Likewise, each of the partners is also at liberty to give his capital in the

way of *Mudarabah*, because, as *Mudarabah* is subordinate to partnership either by reciprocity or in traffic, it follows that a contract of partnership comprehends *Mudarabah*."

"Either of the partners, by reciprocity, or in traffic is at liberty to appoint a person his agent to transact for him, because the appointment of an agent for purshase or sale is a dependency of traffic; and contracts of partnership are formed for the purpose of traffic." (3)

"Each partner, on making payment has recourse to the other for his proportion (provided he has satisfied the demand out of his own particular property, and not out of the partnership stock) because he is the other's agent with respect to his share. If, however, it is not known whether he has paid the price out of the partnership stock, or out of his own property, except from the declaration of the purchaser himself, it is in this case incumbent upon him to produce proof, because the purchaser here advances a claim for property against his partner; (and the partner resists his claim) , and the declaration of the defendant is to be credited."(3)

"Debts can be claimed from the partner who incurs them. Where one of two partners in traffic makes a purchase, the demand for the price lies against him, and not against the other partner (because the contract of partnership in question comprehends agency, but not bail, and the agent is the original with respect to rights).

"A partnership is legal although the parties should not have mixed stocks, according to Hanafees but illegal according to Shafei. The latter maintains that it is illegal, because the profit is a branch of the stock, and the branch is not to be participated in except where the original stock itself is also participated., which can not be so but by admixture. The ground upon which they proceed is that in a contract of partnership, the stock is the subject of the contract, and as such it is indispensably requisite that the stock be participated in by both.

This is the main point with Ziffer and Shafei, insomuch that they allege it to be indispensable, in a contract of partnership, that the stock of both partners be of the same species, for , if otherwise they hold that the contract is invalid because the capital is not being participated in by both. and they also allege (upon the same principle) that mixture is an essential condition. And, likewise they say that it is unlawful to stipulate an excess of profit to either partner, where their stocks are equal, as the profit is a branch of the stock. (3)

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partnership in profit is referred to the contract and not to the stock; because as the contract is termed "as contract of partnership," it is indispensable that the property of the term partnership exist in it; and, such being the case, it follows that the admixture is not essential. Secondly, as the money (of which the stock consists) is not specified, the profit is not derived from the capital, nor indeed from anything else than the transactions (which are had with the stock); because each party is a principal, with respect to one half of the stock and an agent with respect to the other half; and , as it hence appears that partnerships may be established in point of transaction, without admixture of stocks, it follows that it may also be established in the thing which occrues from transaction (namely, the profit), without much admixture; and, as the contract of partnership thus becomes similar to an contract of *Mudarabah*, a similarity of species in the stocks and an equality of profit, are not assential, although the stock of each be equal." (3)

(c) Shirkat Sinnai or *Takabbal* (Partnership in Arts)

"Partnership in Arts is contracted when two professionals (two shoe-makers, or two leather-dyers, for instance) become partners and agree to work and share their earnings in partnership. Imam Shafei regards it illegal while Imam Haneefa considers it quite lawful. According to Shafei, the design of partnership is a participation of gain between the parties, and the partnership in question is not calculated to answer this end, since a capital is indispensable as partnership in profit is founded on partnership in stock, and in the case in question there is no capital. The Hanafee argue that the design of the contract in question is the acquisition of property, which is attainable by each party constituting the other his agent; because upon each becoming agent on the part of the other with respect to one half, and a principal with respect to the other hald, a partnership is established in the property to be acquired." (3)

The main provisions of this partnership are:–

"It admits an inequality of profit, even though the share in capital of the partners be equal. The reason for a more favourable return for one partner is that what each of the partners takes he does not take in the manner of profit but as gain. Gain does not bear the denomination of profit except where the stock and the gain are of the same nature; but they are not of the same nature in the case in question, because the capital, in this instance, is in industry, and the return so acquired, is therefore, not profit but merely a return for

industry. Now industry, is appreciable by means of estimation; and consequently, where both partners agree to receive certain specific proportion, such proportion is an estimate of the industry of each respectively. The exess, therefore, is not unlawful with respect to him whose behalf it is stipulated."

"The work agreed for by either partner is binding upon the other; and either is at liberty to call upon the employer for payment. Whatever work one partner agrees to is incumbent upon him, and also upon the other partner, inasmuch that the employer may require the performance of it from either; and each is entitled to demand payment from the employer for the business performed."

"Unity of trade and of residence are not essentials in this form of partnership; but according to Malik unity of trade and of residence are essential." (3)

(d) Shirkat Wajooh (partnership upon Credit)

"Partnership upon credit is where two persons not being possessed of any property, beome partners by agreeing to purchase goods jointly upon their mutual credit (without immediately paying the price) and to sell them on their joint account. Haneefa legalises this from of partnership while Shafei considers it illegal."

The main provisions are:–

(1) It may include reciprocity: "It may lawfully constitute a partnership by reciprocity: because each partner may become both bail and agent for the other. Where, therefore, two persons capable of bail, make a purchase of any article, on condition that it shall be held between them in equal shares, introducing the term "by reciprocity" into their agreement, it is a contract of reciprocity. If, on the other hand, they express their agreement merely in general terms, it is a ***Shirkat Ainan*** (Partnership in Traffic) because, when thus merely expressed, it is conducted in the manner of such a partnership." (3)

(2) Each is agent for the other: "Each partner is agent on behalf of the other, with respect to what he purchases; because any act which affects another is unlawful, except it be performed in virtue either of agency or of

authority; and as authority does not exist in the present instance, agency is certified." (3)

(iii) Proportionate Profit: "The profit of each partner must be in proportion to the share of each in the adventure. They must hold the purchase between them in equal shares, and the profit must also be equally divided. It will not be lawful to stipulate an excess of profit for one of the partners. If, however, they agree what they purchase shall be held between them in three lots, and that the profit also shall be divided into three lots, it is lawful. In short, if the profit be in proportion to the right of property, it is lawful, but otherwise not. The reason of this is that men are entitled to profit only on account of stock, management, or responsibility; thus the proprietor of a stock is entitled to profit in virtue of the stock; a manager in virtue of his management; and a master artisan (or an entrepreneur) in virtue of his responsibility for his work." (3)

Comparison of *Shirkat* and Modern Partnership

A study of the Western type of partnership shows that it has many things in common with the form of partnership (i.e. *Shirkat*) practised by the Muslims right up to the 18th century. Both forms of partnership are formed by the parties of their own accord with the object of making and sharing profit on mutually agreed terms within the prevailing law of the country. Both require the ability of the partners to be able to contract and terminate the partnership by mutual agreement. Both are dissolved if any of the conditions of the contract is missing or broken by either of the partners. In fact, the main provisions and conditions in both forms of partnership are basically the same, except in the modern form of partnership the element of interest is involved at one stage or another, whereas *Shirkat* is free of this element at all stages. Both are contracts of partnership for sharing profit or loss.

The similarity between British Partnership and *Shirkat* is very real: the types of partners, their rights, duties, and functions and obligations to the third parties in respect of debts, etc., as laid down in the British Partnership Act of 1890 are more or less the same as described under *Shirkat* in the Hedaya. The similarity is so real that one is prompted to say that the formulators of the British Act of 1890 took the Hedaya, transalated by Charles Hamilton under the patronage of Warren Hastings, Governor General of Bengal and published in 1870, in

...and copied the relevant sections of the four types of partnership (i.e. ...) and presented them to the British parliament with some minor changes ...here and there in the original text. This is quite apparent from a comparison of ...of the provisions of the British Partnership Act of 1890 and the terms of ...forms of *shirkat*.

Mutual Assent

...British Partnership Act of 1890, while describing the main terms of the ...ership, mentions the mutual assent by the parties as consisting of a ...offer of proposal and acceptance" whereas *'shirkat* contract' becomes ...ive upon "proposal and consent" of the parties.

Mutual Agreeemnet

...ish Partnership requires a genuine and complete agreement between the ...ies to the contract; while *shirkat* confirms the same by requiring one party ...ay, "I have made you my partner in such a property" and the other ...ying, "I consent."

Purpose of Business

...both forms of partnership, two or more persons can form a partnership for ...poses of business.

Business for Profit

...ch are formed with the main object of making profit.

Rights and Privileges

...ch enumerate almost the same basic rights and privileges of the parties, e.g. ...quality in capital and profit and mutual participation and obligations in debt ...urred by either party.

(f) The British Partnership Act mentions "capacity of the parties to the contract" and *shirkat* refers to it as "competence to contract".

(g) Legality of Business

Legality of the object of the contract is emphasised in both forms of partnership.

(h) Necessity of Agreement

Both forms of partnership intend to create contractual relations through agreement.

(i) Power of Delegation

Both recognise and sanction the need of delegation through the appointment of agents with certain rights and duties.

(j) Dissolution

Both can be formed by the mutual agreement of the parties, and, likewise, dissolved by mutual agreement.

These are just a few example to show the very close resemblance and similiarity between British Partnership law and *shirkat*, and it is indicative of the comprehensive scope and extent of the latter to be able fully to meet the business needs of modern times.

MUDARABAH (LIMITED PARTNERSHIP)

Meaning

Mudarabah is a contract of partnership based on the principle of profit sharing whereby one person gives his capital to another to do business and both parties share in any profit or loss according to mutually agreed terms. The former, the supplier or principal, is called the ***mudarib*** and the latter, the user or manager or entrepreneur, the ***darib***. ***Mudarabah*** is thus a partnership between the supplier of capital, on the one hand, and its user on the other; one supplies the capital and the other the labour, entrepreneurial skill and managerial ability and according to the mutually agreed terms of their contract, both share in the profits (e.g., the ***mudarib*** might receive 60% and the ***darib*** 40% or any other percentage agreed between them). In the case of the venture occurring a loss, the entire loss is borne by the ***mudarib;*** he assumes complete responsibility; and no claim is made upon the ***darib***.

To sum up, therefore, the ***mudarib*** supplies capital to the ***darib*** in return for a specified share of any profits; but in the case of any losses the burden is entirely borne by the ***mudarib*** and the ***darib*** receives nothing for his services. Thus participation in the profits is an essential part of the contract of *mudarubah*. Some regard it as a contract of agency between the principal *(mudarib)* and the agent ***(darib)*** because the entire loss is borne by the principal. The agent losses nothing except the reward of his managerial skill etc. and also he is deprived of his profit as well as wages in case of loss in business.

A participation in the profit is an essential part of the contract. A contract of *mudarubah*, therefore, cannot be established without a participation in the profit, for if the whole of the profit be stipulated to the proprietor of the stock, then it is considered as a ***bazat:*** or if the whole be stipulated to the intermediate manager, it is considered as a loan.(1)

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1. *Hedaya*, op. cit., p.454

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2. Origin

Both the terms ***mudarabah*** and ***muqaradah*** mean to lend money for business. In fact, ***muqaradah*** is equivalent of ***mudarabah*** and is derived from the Arabic word ***'qard'*** which means a loan.

(a) Mudarabah

The people of Iraq called the type of partnership described above as ***'mudarabah'***; this word is derived from the Arabic word *'darb'* which means to walk on the ground or travel on the earth. It is so called because the *darib* is entitled to receive a share of the profit on account of his efforts and labour. In previous time the ***darib*** had to travel in distant lands to carry out his commercial undertakings in order to make any profit. "In the language of the law ***mudarabah*** signifies a contract of co-partnership of which the one partner (namely, the proprietor) is entitled to profit on account of his stock, he being denominated ***rabbi mal,*** proprietor of the stock (which is termed *ras mal);* and other partner is entitled to a profit on account of his labour; and this last is denominated the ***darib*** (or manager) in so much as he derives a benefit from his own labour and endeavour. (1) He gets the opportunity to use capital according to his better judgment and discretion and participates in sharing with the principal (supplier of capital).

(b) *Muqaradah*

The Medinites called this partnership as ***'muqaradah'*** which is derived from the Arabic word ***'qard'***, signifying surrender of right over capital by the owner of capital to the user of capital. This is why it is called loan because the capitalist *(mudarib)* has foregone the right of use of his capital and conceded it to the user of capital *(darib). Muqaradah* is also known as *'qirad'* and there is complete unanimity of opinion among the Muslim jurists with regard to the legality of ***qirad*** (or ***mudarabah***).

Mudarabah was widely practised by the people in the pre-Islamic period and many companions of the Holy Prophet found this form of business very useful and in complete conformity with the basic principles of Shariah. This was one of the forms of business which was found free of the evils of the era of ignorance *(jahiliya)* and, therefore, retained in the Islamic system. According to Ibn Rushd, "There is no difference of opinion among the Muslims with regard to the legality of ***qirad***. It was in vogue in the pre-Islamic period and Islam approved it. There is a consensus of opinion that it consists in giving some capital by one person to another for business. The user of capital receives some agreed proportion of the profit, i.e. any proportion they may agree, one-third, one-fourth, or even one-half."(2)

The Holy Prophet himself worked as ***darib*** in this type of commercial transactions for Khadijah before he was raised to the office of prophethood. It is related by *Ibn Majah* on the authority of Suhaib that ***muqaradah*** is one of the three things blessed by Allah. All the Muslim jurists agree on its legitimacy as a form of business transaction and they formed this opinion on the basis of its wide practice by the companions of the Holy Prophet during his life time. The Holy Prophet knew it and approved of it. Thus the Prophet's approval of what was practised in his time has become the basis of the contract of *mudarabah*.

3. The Nature of the *Mudarabah* Contract

Muslim jurists, (especially the four sunni Imams), have gone to great lengths to find out and determine the exact nature and scope of the contracts of ***shirkat*** and ***mudarabah*** and the difference between them. They have discussed the matter in great detail to find out whether ***mudarabah*** is an act of association or partnership; a kind of agency; or a mixture of both. Despite difference among themselves on the point, the jurists are in complete agreement that ***mudarabah*** is lawful and permissible in Islam providing the following conditions are observed:

a) If two (or more) persons, of their own free will, enter into an agreement whereby one party supplies a specified amount of capital to the other who employs this capital in commerce etc. to make profit for the benefit of this partnership;

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2. Ibn Rushd, ***Bidayatul Mujtahid Wa Nihayatul-Muqtasid,*** Cairo, 1329, p.205

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The people of Iraq called the type of partnership described above as *'mudarabah'*; this word is derived from the Arabic word *'darb'* which means to walk on the ground or travel on the earth. It is so called because the *darib* is entitled to receive a share of the profit on account of his efforts and labour. In previous time the *darib* had to travel in distant lands to carry out his commercial undertakings in order to make any profit. "In the language of the law ***mudarabah*** signifies a contract of co-partnership of which the one partner (namely, the proprietor) is entitled to profit on account of his stock, he being denominated ***rabbi mal,*** proprietor of the stock (which is termed *ras mal);* and other partner is entitled to a profit on account of his labour; and this last is denominated the ***darib*** (or manager) in so much as he derives a benefit from his own labour and endeavour. (1) He gets the opportunity to use capital according to his better judgment and discretion and participates in sharing with the principal (supplier of capital).

(b) *Muqaradah*

The Medinites called this partnership as *'muqaradah'* which is derived from the Arabic word *'qard'*, signifying surrender of right over capital by the owner of capital to the user of capital. This is why it is called loan because the capitalist *(mudarib)* has foregone the right of use of his capital and conceded it to the user of capital *(darib)*. ***Muqaradah*** is also known as *'qirad'* and there is complete unanimity of opinion among the Muslim jurists with regard to the legality of ***qirad*** (or ***mudarabah***).

Mudarabah was widely practised by the people in the pre-Islamic period and the companions of the Holy Prophet found this form of business very useful and in complete conformity with the basic principles of Shariah. This was one of the forms of business which was found free of the evils of the era of ignorance *(jahiliya)* and, therefore, retained in the Islamic system. According to Ibn Rushd, "There is no difference of opinion among the Muslims with regard to the legality of ***qirad.*** It was in vogue in the pre-Islamic period and Islam approved it. There is a consensus of opinion that it consists in giving some capital by one person to another for business. The user of capital receives some agreed proportion of the profit, i.e. any proportion they may agree, one-third, one-fourth, or even one-half."(2)

The Holy Prophet himself worked as ***darib*** in this type of commercial transactions for Khadijah before he was raised to the office of prophethood. It is related by *Ibn Majah* on the authority of Suhaib that ***muqaradah*** is one of the three things blessed by Allah. All the Muslim jurists agree on its legitimacy as a form of business transaction and they formed this opinion on the basis of a wide practice by the companions of the Holy Prophet during his life time. The Holy Prophet knew it and approved of it. Thus the Prophet's approval of what was practised in his time has become the basis of the contract of *mudarabah.*

3. The Nature of the *Mudarabah* Contract

Muslim jurists, (especially the four sunni Imams), have gone to great lengths to find out and determine the exact nature and scope of the contracts of ***shirkat*** and ***mudarabah*** and the difference between them. They have discussed the matter in great detail to find out whether ***mudarabah*** is an act of association or partnership; a kind of agency; or a mixture of both. Despite difference among themselves on the point, the jurists are in complete agreement that ***mudarabah*** is lawful and permissible in Islam providing the following conditions are observed:

(a) If two (or more) persons, of their own free will, enter into an agreement whereby one party supplies a specified amount of capital to the other who employs this capital in commerce etc. to make profit for the benefit of this partnership;

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1. Ibn Rushd, ***Bidayatul Mujtahid Wa Nihayatul-Muqtasid,*** Cairo, 1329, p.205

(b) When either party knows for certain and without doubt what is his share of the expected profit which is a percentage or ratio of the total profit and not a specified amount in the standard money or gold or silver bullion). In the case of loses, the ***darib*** will receive nothing for his work, and all loss will be paid for by the principal (supplier of capital). And in case of no loss and no profit, the ***darib*** will again get nothing for his efforts.

(c) The capital is handed over to the other party (i.e. manager) for the purpose of ***mudarabah***.

(d) The ***darib*** is absolutely free to trade with the capital entrusted to him in any way he thinks best and can take any steps that he deems necessary and proper to obtain maximum profit. Any conditions limiting his freedom renders the contract invalid. (3)

There is consensus of opinion that ***mudarabah*** is not confined only to trade but has wider application; it can be extended to cover any profit-yielding type of trade or business undertaking including industry; for industry is a kind of trade and does not violate any condition of the contract of ***mudarabah***. On this point Imam Shafei is the only dissident from the main stream of Muslim jurists. However his argument that in industry the result is generally controllable and precisely predictable, while this is not the case in commerce where the margin of risk is completely unknown, is not based on very sound ground. The result of industrial enterprise at present is an unpredictable and uncertain as it is in commerce. And there is absolutely no reason why we should not be able to undertake industrial enterprises in the partnership of ***mudarabah***.

Besides, in general, all things, (including business transaction) are permitted, except those which are expressly prohibited by the ***Holy Qur'an*** and ***Sunnah*** of the Holy Prophet; and since we find no restrictive or prohibitive order in the text against industrial undertakings through ***mudarabah***, business on the basis of ***mudarabah*** in all industrial enterprises is therefore quite lawful.

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3. Abu Saud, ***Interest Free Banking,*** paper read at the International Economic Conference held at Makkah, 1976

The duration of the partnership is neither pre-determined nor limited but either party has the right to terminate the contract of partnership by informing the other party. The Zahiris as well as the other four Imams unanimously support this view. However, it seems reasonable that the duration of the contract of partnership must not be limited for it would not give full opportunities to the ***Darib*** to plan and devise long-tem projects.

An arrangement under which the ***Darib*** works with full knowledge that the partnership will stay in force for the foreseeable future is more conductive to efficiency and hard-work on his part. This feeling of security inspires the worker's self-confidence and makes him do his utmost to organise the business in a manner which is likely to yield the maximum profit. However, the actual period of the contract will be a matter for the partners to decide, depending upon the nature of the business. It will be however, in the best interests of the partners to fix a reasonable period for the contract in order to ensure maximum possible profit from the business. A contract of short duration will rarely be of much use for it may adversely affect the interests of the partners by limiting their opportunities.

The right of either party to terminate the partnership at any time he likes without engaging to the business and must be limited to a certain period after the commencement of the partnership. In order to protect the right of both the parties and to secure the maximum yield of profit for each (the very basis of partnership), it is desirable and appropriate to fix a minimum period of time, say two years, after the commencement of the business, before which neither party whom can terminate the partnership. However, after this minimum period, either party is free to terminate the contract by giving resonable notice to the other.

Rules of *Mudarabah*

Al-Jaziri has explained in detail the rules governing the contract of ***Mudarabah*** which give a clear picture of this type of partnership. The rules governing ***Mudarabah*** can be summarised as follows: (4)

Abdul Rahman, ***Muzahib Arbah*** - Vol. 3, pp. 35-36, quoted by Muslehuddin, op. cit.

(b) When either party knows for certain and without doubt what is his share of the expected profit which is a percentage or ratio of the total profit and not a specified amount in the standard money or gold or silver bullion). In the case of loses, the *darib* will receive nothing for his work, and all loss will be paid for by the principal (supplier of capital). And in case of no loss and no profit, the *darib* will again get nothing for his efforts.

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(a) The *Darib* takes possession of the capital stock before he actually starts his business in the capacity of a trustee. This means that he holds the capital or property for the proprietor as a trust. He must therefore look after it and return it if and when it is demanded by the proprietor. However, he will not be held responsible if the property or capital is lost.

(b) When the *Darib* starts business he acts as an agent of the proprietor and represents him within the power assigned to him. The proprietor is, therefore, legally responsible for all the acts and contracts of the agent performed within the limits of his authority. The agent is not legally bound to do anything outside the scope of his contractual duties.

(c) The agent will have a definite share in the profit of the business because participation in profit is the basic purpose of this partnership.

(d) If the agent violated the terms of the contract he will be considered to have acted wrongfully and will be held legally responsible.

(e) If the contract is rendered null the *Darib* will be regarded as an employee and the entire profit or loss of the business will be attributed to the proprietor. However the agent will be entitled to a reasonable reward depending on the nature of the work.

(f) If the whole profit is attributed to the proprietor, the *Darib* will be authorised by the contract to buy a specific quantity of goods in return for his labour but he will not receive any remuneration. The proprietor will bear the expense of all such purchases by the *Darib*.

(g) If the entire profit is taken by the *Darib*, the business transaction will be treated as a loan and he will be entitled to the whole of its profit and will also pay its total loss whichever the case may be. However, he will still be legally responsible for the payment of the loan to the proprietor.

5. *Mudarabah* is a Matter of Necessity

"The contracts of *Mudarabah* are authorised by law. This is necessary since many people have property who are unskilled in the art of employing it; and others possess that skill without having any property; hence there is a necessity for authorising these contracts in order that the interests of the rich and poor,

the skillful and unskillful, may be reconciled. Moreover many people entered into such contracts in the presence of the Prophet, who did not prohibit but rather sanctioned them while several of his companions also entered into them." (1)

Muslim jurists agree on the legality of ***Mudarabah*** but hold widely different views on the nature, terms and scope of the contract and business transaction. As there is no Qur'anic injunction or any explicit instructions in Sunnah in this matter, it is quite natural that the jurists have attempted to define *Mudarabah* and determine rules as to the nature and terms of this business transaction according to their own judgement.

Analogy (Qiyas) is the basis of the various views of the jurists on the nature and terms of *Mudarabah*, their views are not based on any Qur'anic text or Sunnah, of the Holy Prophet. And as it is one of those subjects on which there is no positive or negative Command in the Qur'an or Sunnah, it is undoubtedly permissible because it does not contain any unlawful element. All the divergent views on the various aspects of the contract of Mudarabah expressed by the Muslim jurists are merely their personal opinions and views and hence, not binding on the later generations of Muslims.

6. Main Provisions

The main provisions of the contract of ***Mudaraba*** are as follows:– (5)

(a) Capital in Standard Money

The stock (i.e. capital) should consist of gold and silver coins (i.e. standard money in circulation) and not commodities because of fluctuation in their prices.

(b) Capital is Trust with the *Darib* (Manager)

Whatever stock is given by the ***Mudarib*** (proprietor) to the manager is considered as a trust, because the latter holds the stock of the former with his

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1. *The Hedaya*, op. cit., pp. 454-55.

approval. The manager has no power to sell or pawn it without the proprietor's explicit permission or approval.

(c) Profit must be indeterminate

It is essential that the profit of the partners be indeterminate. It requires that none of them be entitled to a specific amount of profit. This will invalidate a partnership between them because the whole profit may be less than the amount fixed, and participation of profit by both is the essential condition of the contract. "For if the condition of a specific number of dirhams be stipulated with respect to one or other of the parties, the partnership between them with respect to the profit ceases to exist, stince it is possible that the whole profit might not exceed the number fixed, and it is essential that they be partners in the profit. If, therefore, ten dirhams (for instance) is fixed as the portion of one of the parties, the manager (entrepreneur) is entitled to an hire adequate to his labour, because the contract of *Mudarabah* has become invalid, since it is possible that the whole profit aquired may not exceed the amount fixed, in which case there could be no partnership with respect to it." (3)

The share of each partner should be expressed as a proportion or percentage of the profit and not in specific or fixed figures e.g., to fix the share of one of the partner's profit at say £100 would thus invalidate the contract.

(d) No Uncertainty with regard to Profit

It also requires that there is no such condition in the contract that may lead to uncertainty with respect to the profit; for such a condition invalidates the contract, because it destroys its object. (6)

(e) The Stock must be Known

The stock (i.e. capital) must be specified, determinate and known at the time of the contract and must also be in the possession of the proprietor (supplier of capital) so that he can deliver it to the manager.

7. Rights and Limitations of the Manager

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6. *The Hedaya,* op. cit., pp. 455-57.

(a) Possession of the entire stock by the Manager

In a contract of *Mudarabah,* the property (i.e. capital) is supplied by one party, and the labour (and extrepreneurial ability and skill) by the other, therefore, it is indispensable that the property remains entirely in the possession of the manager so that he can manage it effectively. (6)

(b) Management by the Proprietor

Any conditon made by the proprietor as to how the stock is to be managed would invalidate the contract for should such condition exist the stock could never be prossessed solely by the manager, and he would be incapable of managing it; and this in turn would defeat the object of the contract (namely, participation in the profit). (6)

(c) Manager's Personal Discretion

The manager has full liberty to dispose of the stock according to his own judgment and discretion. As contracts of *Mudarabah* are absolute, that is to say, are not restricted to time, place, or other circumstances, it is therefore, lawful for the manager to purchase, or sell, or travel with the stock; to lodge it as a deposit; or appoint an agent. The contract of *Mudarabah* is unrestricted; and the object of it is the acquisition of profit. This can only be accomplished by trade, and the contract of commerce extends to every occurrrence in commerce, and the appointment of an agent." (6)

(d) Stock not trasferable to another person

It is not lawful for a manager to give the stock to another without the prior consent of the proprietor. It is necessary either that an express permission should have been given, or an absolute and discretionary power should have been delegated. In the absence of either, the manager cannot entrust the stock to another person.

(e) Stock not to be loaned to another

It is also not lawful for the manager to lend the stock to another, although his power may be discretionary. Loan is not connected with trade but is a gratuitous deed and, therefore, outside the scope of *Mudarabah;* wherefore by giving a loan, the object (namely, profit) cannot be obtained, since to receive back more than what is lent is not lawful. Giving property by way of *Mudarabah,* on the other hand, is in the nature of trade and a manager in such a case may give stock (which is the subject of it) by way of *Mudarbah* to another, provided the proprietor has empowered him to do so according to his judgement and discretion.(6)

(f) Manager is bound by the Restrictions

The manager is bound by the restrictions imposed upon him by the proprietor in the contract and, under no circumstances, he can deviate from any of them. If a person gives property to another by way of *Mudarabah*, and restricts his management of it to a particular city, country or area or to particular goods, it is not lawful for the manager to act otherwise , because this is in the nature of a commission of agency. (5) The manager may be restricted in his transaction to particular persons or to a particular period. The proprietor may give the stock on condition that the manager buys and sells it with a particular person. The proprietor may likewise limit the contract to a particular period, at the end of which it will expire, because as this is a commission of agency, its continuance is therefore restricted to the period specified. (7)

(g) The Manager must buy property

The manager cannot purchase anything which is not a subject or property, and cannot be taken into possession.

(h) The manager not responsible for loss

The manager is not responsible for any loss or deficiency in the business because he is only a trustee.

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7. *The Hedaya,* op. cit.,pp.456–65.

DISSOLUTION

The contract of *Mudarabah* is dissolved on the death of either partner, lunacy or expatriation of the manager.

Invalidity of the contract of *Mudarabah*

The contract of *Mudarabah* is invalidated under the following circumstances:

(a) " A condition of management by the proprietor of the stock invalidates a contract of *Mudarabah*; because where such a condition exists the stock can never be possessed solely by the manager, whereby he cannot be competent to act with respect to it and thus the object of the contract (namely, participation in the profit) cannot be effected."

(b) " When the proprietor imposes a restriction upon the manager to do the business in any particular part of a city, the condition becomes invalid.(7)

(c) The breaking of the conditions mentioned above under ' the nature of the *Mudarabah Contract* ' or its main provisions.

(d) Power of the Manager *(Darib)*

The manager may lawfully perform the following acts:

(a) Sale of Stock

It is lawful for a manager to sell the stock belonging to the partnership (under *Mudarabah*) in return for cash, or upon trust; because these acts are in the nature of traffic, and, as such, are included in an absolute contract. " As a contract of *Mudarabah* is absolute and is not restricted in time, place or other circumstances, the manager is, therefore, at liberty to act with the stock according to his discretion. He may purchase or sell the stock; give it as an agency or a deposit. This is because the contract is unrestricted and its object is profit-making. The contract also covers every aspect of commerce or business." (8)

(b) May Grant suspension of Payment

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1. *The Hedaya,* op. cit., p.466.

It is lawful for a manager to entrust a reliable friend with the management of the business.

(b) Transfer payment

The manager is also permitted to allow the buyer of stock to transfer the payment of the price to another person with his consent.

(e) All Acts within the contract

The manager is within his right to do all those acts he is empowered to perform by the contract of *Mudarabah*.

11. Comparison of *Mudarabah* and Modern Limited Partnership

A scrutiny of the nature, conditions and terms of the contract of *Mudarabah* clearly shows that it possesses almost all of the ingredients of a modern partnership of the type wherein one of the partners is inactive or dormant. It is freely formed by two or more persons with the purpose of making profit to be divided between them on mutually agreed but fair and equitable terms. The active partner is free to trade with the capital entrusted to him in any way he thinks best and may take any steps that he regards necessary and proper to increase the yield from business within the terms of the contract.

The active partner (manager or *Darib*) has the power, as in any modern partnership of this nature, to sell and buy goods for the partnership; engage people for the business; contract and pay off the debts of the partnership; and perform any other appropriate activities that contribute to the successful operation of the business of the partnership. He is also an agent and trustee of the other partner in regard to the employment of the stock of the partnership. (9)

Like *shirkat*, many of the provisions of the contract of *Mudarabah* (i.e. limited partnership) are almost the same as that of the modern limited partnership according to the British Partnership Act of 1890. The scope and extent of

Mudarabah is likewise reasonably wide enough to embrace modern banking business. In fact , British partnership, as pointed out before, is a *replica of shirkat* and *Mudarabah* practised by Muslims in their multifarious commercial dealings centuries ago.

It may here be emphasised that the term *Darib* (user of capital) is very comprehensive in meaning and includes all the functions of a manager or an entrepreneur in the modern sense. It does not in any way restrict its meaning, as some " modern " Muslim scholars have claimed, to mere physical labourers or workers. The modern *Darib* would use the capital in the various alternative investment opportunities available to him according to his best ability, experience and expertise. Thus, *Mudarabah* is, in fact, a limited partnership between capital (as sleeping partner) on the one hand, and enterprise (as active partner) on the other, for the purpose of joint profit sharing on mutually agreed terms.

9. *The Hedaya*, op. cit. pp.451–71.

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THE BASIS OF *MUDARABAH* CONTRACT

We will now discuss the various aspects of the contract of *Mudarabah* and try to show its relevance and applicability in the organisation and establishment of modern banking.

1. Its Basis is the *Qur'an* or *Sunnah*

Mudarabah is neither commanded nor prohibited by the *Qur'an* or *Sunnah*. It was very common in Arabia before the advent of the Prophet Muhammad (P.B.U.H.) and he together with his companions practised it. Since this useful and beneficial practice was in conformity with the basic principles of *Shariah* it was retained in the Islamic economy.

2. Jurists ' Opinions

Muslim jurists have unanimously recognised the legality of *Mudarabah* because of its need and usefulness on the one hand, and its conformity with the spirit and purpose of ***Shariah*** on the other. In the absence of any clear indication in the ***Qur'an*** or ***Sunnah***, the jurists have widely differed on the nature, terms and scope of the contract of ***Mudarabah***. Some of them have viewed the contract in a very narrow sense that would exclude its possible use in modern banking, while others have taken it in a wider sense, even extending its operation to include modern banking.

The validity of this type of partnership is recognised by eminent jurists such as Burhan ud Din Abu Bakr Al-Marginani (1) and Ala ud Din Abu Bakr Bin Masud

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The four major schools of Islamic jurisprudence, i.e. Henafei, Maliki, Shafei, and Hanbali, agree with minor differences on the terms and conditions of the contract of ***Mudarabah*** and its legality as a form of business partnership. Even Shaukani admits this : " If we probe deep into the origin of ***Mudarabah***, we find that it was a contract in ***Jahiliya*** (the pre-Islamic period) entered into between the parties to earn profit by combining the skill of one with the capital of another. Hence it is said that ***Mudarabah*** has been adopted in Islam not only to meet such emergencies, for according to Ibn Hazm all issues relating to Islamic law have their origin in the ***Qur'an*** and the ***Sunnah*** except Ijmah which has its origin in ***Ijmah*** or consensus."(3)

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3. Basis in Necessity

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2. Abu Al-Walid Muhamma Bin Ahmad Rushd Al-Qurtabi, ***Bidayatul Mujahid Wa Nihayatul Muqtasis***, Cairo, 1329.p.205.
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2. Abu Al-Walid Muhamma Bin Ahmad Rushd Al-Qurtabi, ***Bidayatul Mujahid Wa Nihayatul Muqtasis***, Cairo, 1329.p.205.
3. ***Neel Al-Awtar***, Vol.5—p.267 quoted by Dr. Muslehuddin in his article on 'Interst–free Banking.'

Some scholars have unduly exaggerated the 'rule of necessity' as the only basis of *Mudarabah*. They argue that this form of business was adopted by the early Muslims only as a matter of necessity and their precedence does not give a free licence for all but is subject to certain conditions that require trustworthiness, skill, truth and honesty on the part of *Darib*. Obviously various disciplines or systems have been adopted from time to time by different people because of their need and necessity and no one will ever adopt anything which is useless. It is always necessity that compels people and nations to adopt many things or systems to meet their needs and Muslims were no exception. However, Muslims made sure before using or adopting anything or any system that it does not infringe any rules of the Islamic *Shariah*. And if it did, then ispite of its usefulness and necessity, they managed without it and made alternative arrangements to fulfil their needs.

Further, if a thing was found useful and adopted by the early Muslims and later practised by generations since that time, why shouldn't it be retained or reintroduced in the present economy if it is still beneficial and useful. Why it be assumed now that it has lost all its usefulness and is no longer required? This is surely an arbitrary decision of the so called ' moderns ' who welcome anything that comes from the West, but who question everything that comes from Islam, even the concepts based on clear *Qur'anic* texts. And when people find *Mudarabah* useful and applicable to modern banking, they are taunted by these ' modern ' with such remarks that ' *Mudarabah* ' is based on the ' Rule of Necessity ' which is not free licence for it has its limitations.

4. Limited Scope

(a) It is argued that necessity is the basis of *Mudarabah* and it cannot be limitless. Necessity has limitations as to its extent and time. One writer emphasises this point by saying, " Thus, *Mudarabah*, by nature, is of limited scope and this cannot be denied as it has come into Islam owing to necessity which itself is limited to its extent. Further, the limited scope of *Mudarabah* is proved by the fact that unsecured loans are advanced only to such persons as are most trustworthy and *Daribs* (managers) of this type are rarely to be found. It, therefore, follows that *Mudarabah* is not practicable for banking which has a large number of clients to whom credit is to be supplied." (4)

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4. Tabari, *Tafsir,* vol.3.p.324 Quoted by Dr. Muslehuddin op. cit.

The writer says that "the companions of the Prophet acted upon *Mudarabah*, but in each case it was a single transaction and, that too, with a person of proven integrity and tested moral character". He then quotes one example of the Caliph Umar who gave the property of an orphan on *Mudarabah*, and concludes, " From these facts we can imagine how high is the standard of morality in the contracts of *Mudarabah*. Is it possible for the banks to find *Darib* (manager) of so high a character? Further, would it not be breach of trust on the part of the bankers, if they make advances to such as cannot be relied upon? The writer finally concludes that *Mudarabah* is neither permissible nor suitable for the purpose of banking.(5)

The study of *Mudarabah*, as practised by the companions of the Holy Prophet during his life-time, shows that the whole line of its critics argument is based on fallacious assumptions. They make certain assumptions about the necessary conditions of *Mudarabah;* but completely ignore and reject the possibility of achieving those imaginary conditions; and , then conclude that it is not a feasible instrument for banking in the modern world.

It is natural and understable that only useful and beneficial institutions and systems are adopted by people and Muslims are no exception. But, on the basis of this concept, the conclusion drawn that necessity was the only cause for which the Muslims adopted *Mudarabah*, seems irrelevant. Then restricting the operation of the contract of *Mudarabah* with respect to time and trade is beyond our comprehension. *Mudarabah* was neither prohibited by the *Qur'an* nor by the Messenger of *Allah*. The companions of the Holy Prophet found it very useful and in conformity with the rules of *Shariah* and, therefore, practised it in diverse situations quite effectively with considerable economic gain, and as such, was retained in the economic system of Islam. Who else can put limit as to its extent and scope and play the role of the law-giver?

The argument, for instance, that "it would be a breach of trust on the part of the bankers, if they gave advances to such as cannot be relied upon", shows complete ignorance of the working of the Islamic bank based on the principles of *Mudarabah.*

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5. Shaukani, *Neil al-Awtar,* Vol.5, p.267 quoted by Dr. Muslehuddin op. cit.,

(b) Some Muslim scholars over-anxious in their desire to adopt every Western system, think that *Mudarabah* will hardly find a place as a modern banking institution because of its alleged inherent weakness. They point out that there are formidable difficulties with regard to partial partnership limited by the amount of subscribed capital ; intricacies of control over each and every transaction; the balance between the element of risk (for investment) against the element of security (for saving); and the subtle relationship between the central bank and authorised private banks.

A cursory glance at the working of the Islamic bank based on the principle of *Mudarabah* shows that it will experience none of the difficulties imagined by its opponents; it will have plentiful supply of funds of all types; good and healthy relationship with its clients; and workable and reliable balance between investment and savings, (thereby providing reasonable returns and adequate security to the depositors as well as to the bankers); and will experience a satisfactory relationship with the commercial banks.

(c) Some think that the proposed marriage of *Mudarabah* and modern banks is not a practical one, because, firstly, banks are not allowed to engage directly in commercial and industrial operations, or in any speculative transactions; while *Mudarabah*, they argue, involves all sorts of risky investments. Secondly, who would take the risk? If the bank is prepared to take the risks, then why should it pay profit to the depositors at all? On the other hand, if the depositor himself can take risk, why should he go to the bank?

Such irrelevant questions arise simply because the critics have neither seen the actual working of such a bank, nor have they carefully studied the concept of *Shirkat* and *Mudarabah*. Obviously, we are not thinking of establishing one or two banks on the principle of *Mudarabah* surrounded by a host of modern banks all over the country. In fact the whole modern banking system along with the entire philosophy behind it will be replaced by a new banking order with its own philosophy of interest-free banking.

It may also be pointed out that with the passage of time the very concept of a bank has undergone many changes. The modern banks are no longer operating on the old lines of commercial banking, i.e. short-term or bills etc. The modern

...not only in Western developed countries but also in developing ...tries, are financing industry and agriculture. This function is again not ...fined to short term capital but includes credit facilities for intermediate as ...as long-term projects. All this shows that the distinction between ...mercial banks and other banks, like development banks, is fast ...pearing owing to the structural changes in the economic activities of the ...tries. Commerce is now no longer considered the most important sector ...the banks' activity. Moreover, the investment activities of the banks are no ...ger confined to short-term treasury bill or even long-term government ...ds. Commercial banks have now started making investment in the equity ...es of enterprises which enables them to collect dividends on these shares.

...us it is obvious that the classical water-tight compartmentalisation of ...mercial banks and investment banks is gradually disappearing and the ...ter are moving from purely commercial banking to development and ...stment banking in order to share in the profits from these projects. In the ...t of these developments in the functions of commercial banks, the ...rticipation-sharing activities of the Islamic bank should not appear very strange or ...barrassing to the opponents of *Mudarabah*.

(d) There are others who doubt the ability of *Mudarabah* banks to supply ...short-term loans. They also think that *Mudarabah* banks have a very limited ...ility to advance unsecured loans to honest clients with genuine pressing ...eds. This doubt is again based on a lack of knowledge of the actual working ...f the Islamic bank.

...ven modern banks and other financial institutions have their own method of ...determining the creditability and trustworthiness of their clients and of their ...siness and when they have done so, they may grant a requested loan to those ...ients. Similarly, the Islamic bank will undertake a thorough scrutiny of the ...rustworthiness of its *Daribs* and the viability of their business ventures in its ...wn way; and the completion of *Mudarabah* contracts with its clients on these ...nes cannot be considered "a breach of trust on the part of the bank for ...dvancing loans to its *Daribs.*" It is, therefore, ridiculous to say that ...*Mudarabah* is not practicable for banking because the number of *Daribs* is very ...rge."

If the bank thinks it feasible and desirable, it may ask its *Daribs* to furnish reasonable securities, at least from its new clients, before advancing funds for business on *Mudaraba*. Besides, the *Daribs* will be either established firms of long standing, or individual businessmen of reputation who will be able and willing to meet all the necessary requirements to qualify for loans. In this way many of the doubt and fears and objections raised by some scholars as to the feasibility, suitability and practibility of *Mudarabah* for modern banking will either not arise, or will be amicably settled by the parties. In any case no institution, no matter how strong, both financially and organisationally,can ever "stand the strain of irrational (fraudulent) behaviour," if the whole of society is composed of deceitful and mischievous presons, as some of the critics seem to believe.

5. Black-Market

Another reason why its critics claim that a *Mudarabah* bank would be unworkable concerns the prohibition of interest. They fear that with prohibition of interest, most of the funds would be attracted by the black-market, where money loans would be advanced "at a price or hidden interest." Money holders would prefer to take their savings to the black-market and thereby, deprive the banks of the source of their funds, i.e. *Mudarabah* deposits as well as other types of deposits. Besides, money holders would also try many of their tricks to withhold their savings from the banks, thus curtailing the bank's main supply of money– chief basis of their power of credit creation.

Once again this fear is more imaginary than real because the Muslim state will not apply its law just to banking only but will enforce all the laws of *Shariah* in totallity, covering every aspect of human life, economic as well as non-economic. All fraudulent and deceitful practices such as black-marketing, hoarding, dealings in money for profit etc.,will be forbidden by law. The credit creation practices of the banks, as they are known in the modern financial world, will also be conspicuous by their absence because the banks will not be allowed to create credit nearly amounting to four times the money deposits on the basis of non-existent assets, or assets belonging to other people, i.e. the depositors. The central bank, with the active co-operation of the commercial banks, will be able to meet the credit demands of the community in most effective and constructive ways.

even if there is a partial balck-market in money, it will not effectively curtail the portion of the supply of funds to the banks, because there are multifarious sources for supplying capital funds in the modern economy which are not affected by the rate of interest.

(b) The most important source for the supply of capital in the modern economy is the 'retained earnings' or the reserve built up by different productive units. In the advanced countries, these constitute more than half of the additional funds required for industrial and commercial needs. These funds are not affected by the rate of interest but are the function of other variables such as their possible uses and the probable rate of return on their investment.

(b) Another important source of capital funds in modern times, which comprises people's savings, is the joint-stock companies who use their funds in the form of equity investment, i.e. new investment in shares by various units or companies.

(c) Lending on the basis of interest form only a comparatively minor source of capital funds. Such loans could be employed for Government securities, debentures or bonds in the private sector, and as deposits in the bank.

It is therefore clear that two out of these three alternative sources of capital funds have originated without any regard for interest and that the bulk of the total capital funds takes the shape of equity investment in one form or another. Although a portion of the funds from the third source may be diverted to the black-market, it will in actual practice, hardly find any lucrative investment opportunities in an interest-free economy. We may rightly say therefore that these two new alternative developments in the sources of capital funds fully justify the elimination of interest as a form of reward for capital.

6. It will encourage consumption of investment

Some fear that the attempt to enforce the prohibition of interest will encourage money holders either to spend their 'sterile' liquid money on consumption or will invest it. But this objection seems ridiculous in suggesting that all money holders who had previously invested some of their liquid assets in industry or commerce, will now spend them in consumption or investment through other means. There is a limit to personal expenditure on consumption and even a fool will not unnecessarily waste all or most of his savings in consumption. This may be true to some extent in case of individual savings, but, in modern times, as explained above, bulk of the funds for investment

comes from the financial institutions which will not be affected by this change and will operate within the law of the land.

Besides any increase in consumtion will stimulate production and, hence investment, some of which will be channelled through the banks working on the principle of *Mudarabah*. As for the temptation to invest their money through other sources, experience will teach the money holders, who have been accustomed for years to live on the fixed yield from interest, that in an economy where interest is forbidden, it is more secure and profitable to invest their money in *Mudarabah* banks rather than through individual businessmen or in industrial and commercial firms.

7. Risky and Impracticable

Critics also point to the element of risk involved. They say that it will be too risky for the bank to rely upon a *Darib* (manager) who has not furnished any security for the stock handed over to him, and who is not responsible for any loss that may occur. And if the bank, in order to avoid such risks, tries to supervise and control the activities of the *Darib* (manager), it will entail huge expenditure on the appointment and maintenance of a team of engineers and experts for the purpose; such supervision would also amount to participation in the work of the *Darib* and would render the contract of *Mudarabah* null and void.

Risks become all the more burdensome and unbearable when the *Darib* proves to be dishonest and fraudulent for he can dispose of the bank's property, stocks, goods; or acquire credit and incur debts; or engage servants or pledge any amount of money or goods of the business to others etc. He may make, accept and issue bills and other negotiable instruments in the name of the firm. Above all, as agent of the bank, he can bind it in many ways, through contracts etc, which can prove disastrous for the principal (bank), especially if he is a general agent with powers to negotiate absolute contracts.

Many of these problems are more imaginary than real (we have already dealt with the security problems suggested by the position of the *Darib)*. The new banking system will show in its actual day to day practical working how

easily these problems and others like them can be resolved without catastrophe to either the bank or its clients.

It is true that there is some element of risk in *Mudarabah* based banking but a certain risk is involved in all business transactions and *Mudarabah* is no exception. We have every hope and confidence that efficient organisation, mutual understanding, effective business control and expert advice will greatly reduce the element of risk to an almost negligible degree.

8. Loan for Existing Investment Projects

Critics further allege that the Islamic bank will not be in a position to make advances to persons or firms whose capital is already invested in established businesses and are therefore themselves principals (proprietors). They argue that one cannot be both a principal and an agent at the same time in the same transaction for it would entail a conflict of interest and that is not permissible in the contract of *Mudarabah*. Thus prohibition, according to these critices, means that a large number of applications for short term loans from such persons or firms, who have already established business, cannot be entertained by the *Mudarabah* banks and this imposes a great drawback as well as being disappointment for the would be borrowers.

But the critices have forgotten that there is a very efficient system of short-term credit facilities without interest to meet the needs of such people from a section of the current deposit account in the Muslim economy. There will never be a shortage of funds to meet the demands of individual businessmen or firms for short-term loans under *Mudarabah* based banking, and, borrowers may fear no disappointment on that score.

The position of the *Darib* as a principal and as agent is greatly exaggerated by the critcs, and, in actual practice, this fear will rarely materialise, because a *Darib* who is a partial owner (or partial principal) can hardly claim to be the owner of the entire business (without any legal basis). (6)

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9. Rush for loans at Reduced rate of Interest

Another objection is that when the rate of interest is reduced to zero under an interest-free economy, there will be a great rush on the banks for contracting loans causing the demand for money to exceed its supply. The result will be an addition to the total quantity on the money market, which will lead to inflation with all its evil consequences.

Again, this is an exaggerated fear, because in practice only those people genuinely in need of funds will get loans. Loans will not be given indiscriminately to everyone without verifying their genuine needs and requirements as well as the viability of their business.

10. Doubt about the Basis of Partnership

Some even refuse to recognise this contract as a partnership, on the ground that, in the case of loss, the loss is always borne by the principal *(Mudarib)* and never by the *Darib* (agent), who never loses anything except his profit. This objection ignores the real meaning and nature of labour. Labour, in fact is as good as capital— indeed some claim it is even better than capital in many respects, because it creates capital. In *Mudarabah*, the principal gives his capital and the *darib* his labour, either as skill or as managerial ability, and both share in the profit;the one for his capital and the other for his labour.In fact, it is the *Darib* through his work and by his enterprising skill and diligent efforts who makes the profits; the mere existence of capital could not by itself have created profit without the active help of labour. It is therefore not true to say that *Mudarabah* is not a partnership because *Darib* does not pay anything and does not lose anything in the case of loss. When the venture incurs a loss he does not get any reward for the hard work he has already expended on it. His loss is his hard labour which is in no way inferior to capital.

11. Conclusion

It is our firm opinion, which is based on intensive study of the contract of *Mudarabah* and modern banking, that this contract can provide a suitable operational substitute for the modern interest-ridden banking system. Inspite of initial difficulties and obstacles, a conceptional and workable framework can

be developed upon the principle of *Mudarabah* without invoking the use of interest in an Islamic banking system. It will enable us to organise banking on modern lines capable of meeting all the requirements of industry, commerce and agriculture.

6

WORKING MODEL OF A *MUDARABAH BANK* ON TWO TIER BASIS

Inspite of differences of opinion among the Muslim jurists about the nature, terms and conditions of *Mudarabah*, there is complete agreement that this partnership between the suppliers of capital (*Mudaribs*, principals or depositors) and users of capital (*Daribs*, managers, enterpreneurs or agents) is lawful in Islam. It is a simple agreement of profit-sharing (or loss-sharing) between the principal and the manager who both agree to work together in partnership, one supplying his capital and the other his labour, and both sharing the profit (or loss) on mutually agreed terms.

Even if we view it from purely economic point of view, the conceptional basis of a better banking system will be the one in which capital and enterprise co-operate and participate in business ventures on the basis of profit-sharing (or loss-sharing). This will provide encouragment to profitable enterprises and, at the same time, discourage and, perhaps, eliminate altogether unprofitable ventures and the exploitation of the capital resources by unscrupulous people, and thereby lay the foundation of healthier and balanced economy.

study of partnership and other forms of business organisations in Britain and other parts of the Western World shows that *Mudarabah* is based on equally sound business principles. In order to develop business and banking along health lines, it will therefore be quite appropriate to adopt *Mudarabah* as the basis of banking in an Islamic state. The institution can be modified and improved in structure and organisation to suit the needs of modern times within the Law of *Shariah*. This will enable us to reap the benefits of modern techniques without losing the usefulness of our own institutions and without infringing the basic principles of *Shariah*.

We now have to examine how far the contract of partnership between the

principal and the manager can be applied and extended to banking . It was originally a simple form of partnership contract between the two parties, the principal and the manager. If we apply it to the field of banking, the principle of the contract of partnership will remain unchanged, but the form and scope of the partnership will undergo considerable change to meet the demands of the time. It will no more remain a simple contract of partnership between the two parties, but will involve two separate contracts of partnership, between the bank and the suppliers of capital (depositors) on the one hand, and between the bank and the users of capital (*Diribs* or entrepreneurs or managers) on the other. Thus, there will actually be two separate contracts between three parties: the suppliers of capital (depositors or *Mudaribs)* ; the intermediary link the bank; and the users of capital (*Daribs* or managers).

The bank will receive deposits of various kinds from the public on the basis of *Mudarabah* and will share the profit (or loss) with them on certain mutually agreed terms. The bank will enter into a partnership contract with the depositors, in accordance with the nature of their deposit , and will issue them certificates of partnership or treat them as mere saving or current deposit accounts, as the case may be, containing details of the terms and conditions of the contract. The bank will use these funds by advancing loans to individual businessmen or firms on the same principle of profit sharing with them. The bank will also enter into a partnership contract with these businessmen or firms (commonly known as entrepreneurs or managers), and issue them certificates of partnership, containing the details of the terms and the conditions of the partnership.

In this tripartite relationship– principal–*Mudarabah* Bank– entrepreneur– the bank will have direct contact both with the principals as well as the entrepreneurs . It will act as intermediary between the financiers (i.e. principals) and users of finance (i.e. entrepreneurs). It will act as an instrument for mobilising the savings of the public on the basis of profitsharing and then giving his capital to entrepreneurs, firms, industrialists, etc. for investment on the same principle of joint profitsharing. Thus, *Mudarabah* joint profitsharing bank and its shareholders will share the profits as well as losses of all enterprises: businessmen who obtain capital from *Mudarabah* Bank will have to share profits with them on mutually agreed terms and the bank on receiving its share of the profits will in turn have to share it with *Mudarabah* depositors (i.e. principals in investment account) on mutually agreed terms. A part of the

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profits will be left over for the *Mudarabah* bank and this along with its income from fees and commissions for banking services will be its gross banking profits.

This tripartite relationship can be of two kinds: partnership on *Shirkat* or partnership on *Mudarabah*. In *Mudarabah* partnership, liability for losses falls on the *Mudarabah bank*, but if the entrepreneur also invests his own capital along with that of the bank , then the bank will only bear liability for losses on its own capital and the entrepreneur will bear liability for losses on his. In pure *Mudarabah* partnership, all liability for losses falls on the *Mudarabah bank* and nothing is incurred by the entrepreneur.

In the second form of partnership, i.e. *Shirkat* partnership, the *Mudarabah banks* actually participate in business management and control with the entrepreneur and also share in the investment capital of business with him. Thus, in this form of partnership both the parties participate in the business at all levels and also share in the capital. Liability for losses will fall on both parties in proportion to their invested capital. In other words, both will share profits as well as losses in proportion to their share of the capital.

A two-tier partnership will therefore be the basis of the Islamic bank; one tier representing the *Mudarabah bank* and the depositors of capital; and the second tier representing the *Mudarabah bank* and the entrepreneurs *(Daribs)* . This two-tier partnership will work smoothly and successfully only if the bank receives a higher profit from the second tier to enable it to share it with the first-tier and still make a profit. It is therefore necessary and desirable that the bank should get a reasonable share of the profits, as a ratio or percentage, from the second-tier, so that even after sharing it with the first-tier, it still makes some profit; otherwise it will not be able to meet its obligations and commitments. For example, in the second-tier, profit will be shared between the bank and the entrepreneur, say, at the ratio of 40:60 (or in percentage 40% for the bank and 60% for the entrepreneur) the bank receiving £40 of every £100 of profit, and the entrepreneur getting £60 of every £100 of profit. In the first-tier, profit will be shared between the bank and the depositor at the ratio of, say , 60:40 (or in percentage 60% and 40% respectively), the bank getting £60 and the depositor £40 of every £100 of profit from the business.

e total investment of the *Mudarabah* bank is, for instance, £1,000,000 and e profit from the business enterprise comes to about £10,000 at the rate 0 per cent, then the share of each of the three participants according to mutually agreed term will be as follows: in the second-tier, the epreneur will get a net profit of £6,000 (i.e. 60 percent) and *Mudarabah* 4,000 (i.e. 40 percent). Now the bank has to share its profit with the sitors at the same ratio: Bank will therefore receive £2.400 (i.e. 60 percent 4,000) and the depositors £1,600 (i.e.40 percent of £4,000 . Thus the l percentage of the profit will be 2.4 for the bank, 1.6 for the depositors, 4 for the entrepreneurs. Since the difference between the overall ntage share of the entrepreneur and the other two is quite large, it will be ssary to revise the percentage share in the second tier in a way that gives a onable profit to all the participants without injuring the interests of any of

e main source of income of the modern commercial banks is the difference ween the rate of interest they receive from debtors and the rate of interest y pay to their depositors. On the other hand, the main source of income of Islamic bank will be the difference between the profit it receives from the epreneurs, as a ratio or percentage of the total net profit of the business, the ratio or percentage of its share of the profit it gives to the depositors. other word, the difference between the profit-sharing ratio or percentage of second-tier and the first-tier will determine the extent of its profit.

w the ratio or percentage of profit-sharing is determined between the bank the depositors on the one hand, and between the bank and the epreneurs on the other, is not important. Whatever the relevant factors , and in whatever manner the ratio is fixed neither will alter the fact that the k will, on average, make a profit from the two-tier profit arrangement, herwise it will go out of business.

at will actually decide the ratio or percentage of the profit for each partner two-tier system will depend upon the prevailing circumstances and the icy of the central bank of the country. In normal circumstances, the ratio or entage of profit will be determined by the bargaining strength of each ner in their mutual negotiations. In abnormal circumstances e.g. during a r or emergency, it will be greatly influenced by a number of outside tors:

profits will be left over for the *Mudarabah* bank and this along with its income from fees and commissions for banking services will be its gross banking profits.

This tripartite relationship can be of two kinds: partnership on *Shirkat* or partnership on *Mudarabah*. In *Mudarabah* partnership, liability for losses falls on the *Mudarabah bank*, but if the entrepreneur also invests his own capital along with that of the bank , then the bank will only bear liability for losses on its own capital and the entrepreneur will bear liability for losses on his. In pure *Mudarabah* partnership, all liability for losses falls on the *Mudarabah bank* and nothing is incurred by the entrepreneur.

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actors:

1. Influence of the Government

The Government of the country may regulate the ratio or percentage of profit between the three parties. If the Government wants to expand the economy, it will tend to change the ratio or percentage of profit in favour of the entrepreneurs and the depositors and against the interest of the bank; on the other hand, if it intends to reduce the quantity of money in circulation, it will try to change the ratio or percentage of profit in favour of the bank and against the interests of the entrepreneurs and the depositors.

2. Influence of the Central Bank

The central bank may, in view of the over-all economic situation or national interest of the country, consider it appropriate and desirable to make slight changes in the terms and conditions of the two-tier agreement between the three parties regarding the division of profits between them:–

(a) For example, if the central bank is following an expansionary policy, it will wish to increase the share of the depositor and the entrepreneur in the profits of the partnership at the expense of the bank; . On the other hand, if it is supporting a contractionary policy, it will increase the share of the bank in the profits of the business of partnership at the expense of the depositors and the entrepreneurs.

The working arrangement described here under the two-tier system is known as the ' *Mudarabah* Deposit Account 'commonly known as the ' investment deposit account ' in modern banking economies and it constitutes the main profit-earning activity of *Mudarabah* bank in an interest-free economy. There are, however other kinds of deposits and subsidiary services and banking activities which do not form a major profit-earning function of the bank, but constitute a significant part of the banks ' services for their clients. But the real success of interest-free banking system rests upon the success of its main profit earning activities which, in the last resort, means its ability to ensure an adequate supply of loanable funds for the industrial and business section resulting in reasonable profits for all parties involved.

Benefits of this system

...re fully convinced of the practability of this system and have firm belief ...e, once it starts functioning, it will provide a resonably balanced economic ...em free of many of the evils of modern banking.

There will be complete synchronisation between saving and investment ...en the commercial banks are organised on interest-free basis in the two-tier ...em because capital funds will be available in one form and for one purpose ...ly, i.e. for investment, generally known as ' risk capital'.

All cyclical fluctuations will be conspicuous by their absence in this ...omy for there will be neither over-investment nor under-investment of the ...sh capital ' in any sector of the economy. Capital funds will flow normally ...o the investment sectors at the required rate without causing any unnecessary ...urbance in the behaviour pattern of ' prices of goods ' or ' profits ' through ...stment or the lack of it.

The stability of the economy will be further strengthened by the ...-existence of an unlimited quantity of unreal money in the form of credit. ...e Islamic banks will not be allowed to create ' unreal ' credit nine times the ...e of their original deposits as is done under the modern banking system. ...ere will be no possibility of over-expansion or under-expansion of credit ...d, therefore, no fear of dis-equilibrium in saving and investment. (1)

Under the new arrangement the economy will not, again and again, fall victim ...o depression, resulting in inflation and unemployment as in Western ...economies, but will remain stable at almost full-employment level, safe from ...e evil effects of depression as well as over-expansion. Hayek has very ably ...d lucidly summarised the fate of Western man living under conditions ...eated by the modern banking system in these words: (2)

" It is not within their power to do away with some fluctuations, seeing that ...e latter originate not from the policy, but from the very nature of the ...odern organisation of credit. So long as we use bank credit as a means of ...rthering economic development, we shall have to put up with resulting trade ...cles. They are in a sense, the price we pay for a spread of development ...exceeding that which people voluntarily make possible through their savings ...d which, therefor, has to be extorted from them."

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1. For details see Reserve Ratio under **Central Bank**
2. Hayek, F.A. Von, ***Monetary Theory and Trade Cycle***, pp.189–90.

4. In the two-tier based interest-free banking system over-expansion as well as under-expansion of credit, and hence, over-investment as well as under-investment of capital will be completely eliminated from the economy. Funds will flow steadily all the time into the investment sector according to the requirements of the economy as a whole, and no sector of the economy will ever face the problem of over or under-investment. This balance (or equilibrium) between the two variables (i.e. investment and savings) will be achieved and also maintained at the required level, keeping in line with the demands of the economy and the national interest, by the willing co-operation of the commercial banks and the central bank of the country. Their mutual financial policies and the operation of different Reserve Ratios by the commercial banks with the co-operation and under the direction of the central bank, will help in the adjustment of this eqilibrium at he proper and desired level.

5. The parties in the two-tier system under interest-free banking will enjoy greater profits because they will not have to pay the extra cost of capital in the form of interest. Thus, with the reduction in the cost of capital, the margin of profits on all investments will expand in comparison with the yield from the equivalent investment sectors in the interest-ridden economies. This will quite naturally give a boost to the economy partly through the development of low profit projects, which are not feasible under the present banking system because of the existence of interest on capital; and, partly through the efforts of the bank and the entrepreneurs who will work harder because of the incentive of higher profits. (Both these factors will help to increase the profits of the parties under the new arrangement.)

Organisation of *Mudarabah* Banks on the basis of Partnership

As pointed out in the introduction it must be realised at the outset that before we can take any practical steps to establish and organise interest-free banking it is essential that the Muslim states be willing to give the undertaking of their whole-hearted support and be prepared to enforce it by law. To ensure the system's successful working once it gets under way they must be willing to forbid all such practices and transactions which are contrary to the purpose and philosophy of interest-free banking since these are bound to hinder its progress.

Riba (i.e. interest) in all its forms, in cash or kind, and all other dealings in money which carry interest, directly or indirectly, must be declared illegal.

(c) There must be no distinction between a commercial and non-commercial bank operating in the country. Every Islamic bank, under interest-free banking, should be able to do commercial as well as non-commercial business without any restrictions. This would not place any undue burden on the banking system as the distinction between a commercial and a non-commercial bank is also disappearing even in the Western economies.

(d) The distiction between a ***Mudarabah*** deposit (i.e. an investment deposit or profit-making) and other types of deposits known to modern banking practice must be made clear by law to the public by every ***Mudarabah*** bank.

(e) Banking should be considered a public service and therefore be either partially owned or controlled by the state. Banks would then be in a better position to direct production along right channels and to the required amount through extending or withholding credit facilities in accordance with the local needs of the people, or the national interest of the country.

(e) The ***Mudarabah*** banks should also be required to provide their services in the settlement of foreign trade payments and foreign capital investments (if any) in the best interest of the country. These banks would be in a much better position to facilitate an increase in the volume of foreign trade and in settling payments than the modern banks, which are simply profit-making institutions. Above all, these banks will not, in any way, exploit foreign trade at any stage at home or abroad though they may, charge a reasonable commission for their services to cover their costs, but since it will not contain any element of interest or profit, it will be much less than that charged by the modern banks.

(f) The ***Mudarabah*** banks will be completely different from modern commercial banks in more ways than one. Modern commercial banks do only commercial banking; ***Mudarabah*** banks, on the other hand, can do pure commercial banking as well as investment banking. In fact, investment banking is their main source of revenue. These banks are also expected to play a leading

role in financing development projects in co-operation with the Islamic Central Bank. Thus, *Mudarabah* banks will be doing three types of banking at one and the same time and place. They will combine commercial banking, investment banking and development banking in one banking system called *'Mudarabah* Banking'.

Its Organisation

The Islamic banking system is organised on the principle of partnership . The people who participate in it, directly like the shareholders, or indirectly like the depositors of various types, are all its partners in different capacities and degrees, all sharing in its profits (as well as losses) according to the nature of their deposits.

The promoters of the bank – the shareholders who put up the capital from among themselves – will determine its total share capital and the value of each share and then divide the share capital among themselves in any proportion they like. It can be divided equally between them, each shareholder buying an equal number of shares of equal value, or unequally, different shareholders buying a different number of shares of equal value. Whereby some will have contributed more capital than others. The promoters can also fix the minimum as well as the maximum number of shares each shareholder may buy.

The shareholders participate in the bank on the principle of *Shirkat Ainan* (i.e. limited or free partnership). They are the active partners with unlimited bility, and are held fully responsible for the repayment of loans and other debts and liabilities of the bank in cases of loss in business or bankruptcy. They organise banking business with their own capital and invite more capital on the basis of *Mudarabah* (i.e. limited partnership), and also *Shirkat* (unlimited partnership), from the public. The *Mudarabah* partners contribute capital only and do not participate in the buisness of the bank but only share its profit (or loss) with it. *Mudarabah* partners, unlike shareholders, are the sleeping partners in the business.

The minimum and maximum number of shareholders, as allowed within the law of the country, and the amount of capital to be supplied by each are

worked out by the promoters of the bank. There is a partnership contract between the promoters to decide the manner in which the capital is to be used, and other matters relating to the business, banking or investment etc. of capital. All problems relating to the acquisition of more capital for the purposes of investment through loans are also settled by the management (i.e. the promoters) at the time of the contract.

Under the British law, any two, but not more than 50 persons, may form an incorporate (private) company in the manner prescribed by the law. They cannot invite public subscription for any shares. On the other hand, a partnership can be formed by any two, but not more than 10 persons in the case of a banking partnership. In the case of Non-banking partnership, there is no such limit. For *Mudarabah* banking (limited partnership), we think a minimum of two persons is quite reasonable with maximum of between 15 and 20, but the number of partners must not be very large.

The shareholders must agree at the time of the formation of their partnership for *Mudarabah* banking on the following:–

(a) Division of Profits

The manner and in what proportion profits will be divided among themselves. This must be clearly laid down in the partnership contract leaving no vagueness about the matter. As a matter of principle, it is desirable as well as fair that profits should be divided among the shareholders in proportion to the amount of their share capital. Similarly in the case of losses the same principle should also apply, i.e. losses should be divided among themselves in proportion to the amount of their share capital. The time or date of the distribution of profits and whether they are to be distributed annually, must also be decided along with other relevant matters.

(b) No Direct Involvement in Business

The bank will not directly enter into any kind of business enterprise but will advance loans to other parties on the principle of *Shirkat* or *Mudarabah*.

(c) Normal Banking Business

The bank will carry on normal banking business i.e. accepting demand (or current) deposits and savings (time) deposits without interest, while also render other banking services on commission.

(d) Borrowing of Money

The bank will be able to raise more funds through loans under interest-free loan scheme, if needed, to expand its business or on the basis of *shirkat* or *Mudarabah*.

(e) All business matters of the bank will be decided through mutual agreement.

(f) Each shareholder will be free to receive a loan or to do any other business in his individual capacity, or on *Shirkat* or *Mudarabah* with any other individual or firm.

(g) Each shareholder is at liberty to leave the partnership at any time he likes. It is however, desirable that reasonable notice is given before leaving so that there is sufficient time for settling the accounts, etc.

(h) In the case of the death of any shareholder his heir or heirs can join the partnership under the same conditions as himself with the consent of other parties, or his shares along with profits (or losses) will be inherited by his heirs should he have so willed. The business of the bank is not affected in either way. In establishing a *Mudarabah* bank the promoters will have to go through the following stages:—

(i) They will first have to agree themselves on the conditions, and the terms [illegible]he total share capital, and on the share of each partner in it and in profits. [illegible]ey must then also agree on the terms and conditions on which they will [illegible]vite the public for *Mudarabah* and *Shirkat* partnership; the ratio or percentage according to which profits (or losses) will be divided between the shareholders and *Mudarabah* depositors on the one hand and the shareholders and the *Mudarabah* entrepreneurs on the other and any other matters relating to profits.

(ii) After reaching mutual agreement about the terms and conditions of the partnership, its investment business on the basis of *Mudarabah* and its general banking business, they have to seek the help of a lawyer to draft a document of partnership containing all and each of these conditions along with conditions and terms covering every other aspect of business.

[illegible] When the document of partnership is completed, they will register the [illegible]me of their partnership (which will include the names of the partners with [illegible]eir respective share capital) along with the document, with the Registrar [illegible]der the Registration of Business Names Act or any other Act which requires [illegible]e registration of such agreements.

[illegible] The document of partnership submitted by the partners to the Registrar [illegible]ould define and state the rules and regulations and powers of the partnership. [illegible]y act of the management beyond the powers defined in it is 'ultra vires' the [illegible]rtnership and void. It must state the name of the partnership e.g., Oriental [illegible]nking and partners etc. and the address of the registered office in which the [illegible]rtnership is formed. It must also state that liability of the members is [illegible]mited and give details of the share capital, showing its total amount and [illegible]vision into shares e.g. total share capital of the partnership; £1,000,000; [illegible]vided into 10,000 ordinary shares of £100 each. etc.

[illegible] should also contain the internal rules and regulations setting out the [illegible]ocedure and the way in which the partnership business will be conducted. It [illegible]ould show the practical day-to-day machinery through which the work of the [illegible]rtnership will be carried on. This document is filed with the Registrar at the [illegible]me of incorporation and any alteration or change must also be filed with the [illegible]gistrar. The Registrar will then issue a Certificate of Incorporation of the [illegible]w partnership from the date stated therein, which will also contain the [illegible]gistered number allocated to the partnership.

(v) The promoters now are ready to take practical steps to launch their [illegible]vestment venture. It is entirely up to them to decide when to commence the [illegible]vestment phase of their banking business, but a limited company must start [illegible]s business within a calendar year from the date of incorportion, otherwise it [illegible]ll become void and will automatially cease to exist. The promoters may, [illegible]owever, commence their normal banking business, i.e. accepting various kinds [illegible]f deposits from the public after the Commencement of Business Certificate [illegible]om the Registrar, and delay its investment business till the total or major [illegible]rtion of the subscribed capital is collected.

(vi) By now the bank will have collected a large amount of subscribed capital [illegible]om the *Mudarabah* depositors and a reasonable amount of capital through

various kinds of deposits. A portion of the capital from these deposits may be invested if the depositors are willing to enter into *Mudarabah* partnership with the bank and accept its terms and conditions of profit-sharing. It is to be hoped that many of the depositors of saving accounts will be quite ready to do this with the bank and become its *Mudarabah* partners. However a great majority of the depositors of current or savings account will continue to remain ordinary customers of the bank without entering into any business deals. Such customers will be treated like ordinary depositors of current (or savings) accounts under modern banking and will be using the services of the bank for their normal business purposes.

By this stage the bank will be fully operational as a financial institution doing all kinds of banking business like any other bank. It will be managed and controlled by a board of directors (elected by the shareholders) with the help of paid staff, including managers, clerks, etc. Though the policy matters are decided by the partners (i.e. the shareholders), the actual running and management of the bank is in the hands of the Board of Directors.

Main Participants

The main categories of the bank's participants are as follows:–

(a) **Partners in *Shirkat***

They are the promoters and real controllers of the entire business of the bank. They are the people who initiated, organised and started the whole scheme; in fact, they are the actual managers and controllers of the whole business. Their liability is unlimited and they take all the risks that may arise out of the business. In case of loss, each of them is liable for the debts of the company to an unlimited extent. If the total debt or loss of the company exceeds its share capital or total assets, it will be recovered to the full from the private assets of the partners who may sometimes have to sell all their moveable as well as immoveable property.

The shareholders (or the partners) will be issued with Share Certificates stating the number of shares and the value of share capital and also the terms and condition of partnership.

The partners are technically called the shareholders because they have subscribed capital to the partnership by buying its shares. Each shareholder is the owner of the partnership business in proportion of the value of his share capital to the total capital of the company, and he participate in its profit (as well as loss) accordingly.

(b) ***Mudarabah* Depositors**

The people who deposit their money in the bank for investment on the basis of *Mudarabah* (limited partnership) are called its *Mudarabah* depositors. They are issued with *Mudarabah* certificates equivalent to the value of their deposits and are treated like shareholders except that the liability of each *Mudarabah* depositor unlike the shareholder, is limited to the extent of his capital. Each *Mudarabah* depositor is a partner in the business of the company and shares in its profit as well as its loss.

The *Mudarabah* depositors are the sleeping partners of the company and do not take any active part in its business, but have the right to check its accounts etc.

(c) **Other Depositors**

The people who deposit their savings or surplus money in the bank in various deposits for safe custody, or convenience are also its depositors. They include people who deposit their money in demand (i.e. current) or savings (i.e. deposit) accounts.

(i) **Demand (or Current) Depositors**

The people who deposit their money in the bank for convenience of transfer or withdrawal of funds are called its demand depositors. They are able to withdraw any amount of their money on demand without any restrictions. They are treated like current account holders in the modern banks and are guaranteed payment of their money on demand under all circumstances, irrespective of any profit or loss to the bank's business.

(ii) **Depositors in Savings (or Deposit) Account**

The people who keep their surplus money in the bank for savings for unspecified periods are its savings depositors. If they agree to the terms and conditions of *Mudarabah*, they are treated like *Mudarabah* depositors, otherwise they are its ordinary demand depositors. If they decide to become its *Mudarabah* depositors, they are issued with *Mudarabah* certificates equivalent to the value of their deposits and enjoy all the rights and benefits of *Mudarabah* depositors.

The depositors under these two categories are not entitled to any share in the bank's profits. The bank may or may not demand a service charge from them that is entirely up to the bank, but it is required under the regulations of the Islamic Central Bank to maintain a certain percentage, say 40 per cent of its demand (and saving) deposits, as a Reserve Fund for short-term interest-free loans to the needy businessmen.

(iii) Loan Depositors (or Creditors)

The individuals or firms which advance loans to the bank to meet its multifarious needs are its creditors (or loan depositors). They are not paid any share of profits nor do they share in its losses. Their loan is guaranteed and must be rapaid under all circumstances, irrespective of profit or loss. Technically, they are not the real participants and they have no relationship with the bank except when they advance some loan for a certain period of time. As soon as the debt is repaid, their link with the bank ends there.

Investment Activities

All banking activities relating to the investment of capital are organised on the basis of limited partnership *(i.e.Mudarabah)*. The bank may also invest its capital on the basis of unlimited partnership *(i.e. shirkat Ainan)*, if it thinks it will be in the best interest of the bank and the community. In order to provide adequate safeguards against the probability of loss, it would be wiser and in the best interest of the bank, the community and its shareholders to keep a certain percentage of the annual profits in the Reserve Fund to meet situations of loss, damage, and other unforeseeable emergencies. If there is loss in any year, it will be paid from the Reserve Fund without causing any unnecessary distress, or harrassment to the shareholders. Even if the liability of the shareholders will

limited without any upper limit to their legal responsibility for paying off debts of the bank, the Reserve Fund accummulated over a number of years be more than enough to meet such unforeseeable situations and their ility for all practical purposes will become limited.

stment in other Companies Shares

very useful means of investment for the commercial banks is to buy government industrial shares of successful industrial and commercial panies. In modern times, all banks and financial institutions invest a rtion of their capital in the purchase of such shares. These shares are bought d sold in the open market like any other commodity. The holders of such res are the owners of the company up to the value of their shares and ive profits annually or bi-annually on them.

buying and selling of shares with suitable modifications can be maintained the Muslim economy. All manner of mal-practices of the modern stock kets and the speculative buying and selling of shares will be forbidden by w. All shares which carry a guarantee of minimum profit , or are given special stment in the nature of interest will also be declared illegal. There is every elihood that, after such measures, the market for common stock will develop d grow on healthy lines and the prices of all shares will be determined in the en market by the actual profit-earning capacity of their respective panies. This will guard the Muslim economy from the scourage of the dern stock exchange and speculative buying and selling and will thereby ep it free from the evils of trade cycles, the offspring of the interest-ridden nomy of the Western world.

best way for the Islamic bank to earn some profits from its liquid funds d maintain their liquidity as well will be to buy government industrial shares d shares of different industrial and commercial firms. The diversification of estment will ensure overall profit on its investment at all times. If there is a s or no profit on some shares, it will be neutralised by profits on others. It is ays the best policy to spread out investment by buying various types of res in the market to avoid the risk of loss.

The purchase of shares has another advantage for the bank: it will help the bank to maintain its liquidity ratio at a reasonable level at all times. It can sell these shares in the market whenever it likes to meet its financial commitments. In fact, the bank's stock of shares is equivalent to hard cash or liquid money because it can be sold at any time for cash.

NCTION OF A *MUDARABAH* BANK

e main function of a ***Mudarabah*** bank will be to invest funds on the nciple of *Mudarabah* (i.e. by advancing money to enterprises for investment industry, commerce and agriculture with the object of profit-sharing) as plained above; but the commercial banks in the two-tier system of banking ll, in addition, perform many other functions. They will receive deposits m clients for safe custody and convenience; issue traveller's cheques, nsfer sums of money from place to place, take delivery of various kinds of ds on behalf of their clients, making payments for them and acting as ancial advisors or as trustees to them on payment of commission or fee, buy es issued by government and by industrial concerns for collecting dividends well as for keeping readily convertible cash; and advance short, medium, d long-term loans to industry, agriculture and trade.

e bank's main business will be advancing money to enterprises for estment in industry, commerce and agriculture. It will also deal in shares d common stock issued by the government and private companies. The bank ll also give short-term interest free loans to businessmen out of its loanable nds kept for this purpose from the demand deposits of the people. Thus, in o ways the Islamic commercial banks will be engaging themselves on a large le in financing important national industries and concerns.

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Now the commercial banks are widening the scope of their old classical commercial banking structure to include development and investment banking, and are thus engaging in profitable projects. It would not be surprising if they become more profit-sharing than mere interest-earning bodies in the not very distant future. Thus, an Islamic bank, like any other modern bank, will provide a variety of services to the community in various capacities.

1. Accepting Deposits

Like any other modern bank, the Islamic bank will accept deposits of all kinds from the public, who have according to Keynesian analysis different motives in depositing their savings. The chief motive of the main categories of depositors, according to Keynesian approach is 'liquidity preference' and saving. Let us examine how this analysis of 'motives' applies to the three main categories of deposits in the modern banks, namely, (a) Time or Fixed Deposits; (b) Savings Account Deposits; and (c) Demand or Current Account Deposits.

(a) Time or Fixed Deposits (i.e. *Mudarabah* Deposits)

The main and primary motive of the depositors is 'investment motive' or finance (i.e. profit) motive'. Their chief object is to earn some income on funds which they are not using. These depositors earn interest on their deposits under the modern banking system. The very nature and purpose of these deposits will undergo a fundamental change under interest-free banking. These deposits will be called ***'Mudarabah'*** or 'investment' deposits and will constitute the main profit-earning activity of the bank on the principle of profit-sharing according to the two-tier banking system (chapter five). If there is a greater demand for such funds than are availabe under this category, they can be obtained from the second type of deposits discussed below.

However, in cases of excessive demand for investment funds, the bank can call at the central bank of the country for loans for this purpose as is often the case under the present banking system.

(b) Savings Account Deposits

These deposits are also chiefly motivated by the desire to save some capital

at the same time, to earn some profit on them. The chief difference ween the Time Deposits and the Savings Account Deposits lies in the ure and disposition of the people who have deposited these funds. The Time posits are mostly deposited by businessmen and other wealthy members of e community, who have excessive funds which they cannot utilise and nage for themselves because they lack information about investment portunities and or because they lack the initiative to take a risk themselves. r this category of depositors, the primary motive of saving is 'investment' or nance (i.e. profit) motive' while their secondary motive may be precautionary motive' in the Keynesian sense.

the other hand, the primary motive of the depositors in the Savings count Deposit is 'precautionary motive', while their secondary motive may e 'investment motive' or 'finance (i.e. profit) motive'. The depositors in this tegory usually belong to the middle classs who resort to saving chiefly cause of 'precautionary motive' unlike the Time Depositors. They prefer to posit their spare funds in the Savings Account because they wish to earn me income from their savings. Under the modern banking system the banks vest these funds in short-term loans on interest to other people, or securities order to keep 'ready money' available on demand. Under interest-free nking system the banks may invest whole or part of these deposits on the sis of profit-sharing ***(Mudarabah)*** or buying the shares of some successful dustrial or commercial firms in order to keep part of its funds in readily nvertible cash form.

(c) Demand or Current Account Deposits

The primary purpose of those people who deposit their funds under this tegory is the 'transaction motive' for keeping the extra liquidity readily ailable in a convenient form for spending and making payment to other ople. The aim of these depositors is not to earn any income on their deposits t only to keep them safe and readily available for use. The banks do not pay y return or interest to these depositors, but instead charge them a nominal m to cover expenses incurred in maintaining their account. Thus, demand posits are treated as loans payable on demand and no profits are paid to ese depositors. Repayment in full is guaranteed by the central bank under all cumstances no matter what happens to the bank. These depositors will be ued with cheque books for their daily use to draw, transfer or make

payments to other people from their funds whenever they wish without any limit.

The Islamic bank will not invest any part of these deposits for making profit, but will keep a reasonable amount of it for making short-term interest-free loans *(Qard al-Hasna)* to needy industrialists and agriculturists, who may not otherwise qualify to receive a loan. It is quite appropriate for the bank to give interest-free short-term loans as well as over-draft facilities from this category of deposits for which it pays nothing to the depositors. However, a small portion of these deposits may be used for buying industrial shares which keep the funds in near liquidity form and, at the same time, will earn some profits. If the profit from this source is sufficient to meet the expenses of the bank, then it may not charge the demand account depositors for maintaining their account, but if the cost of book-keeping, administration, clerical work etc., becomes unbearable, it may charge a small fee from them to cover its expenses, like the modern banks.

2. Banking Business

The experience of banking over a period of time has shown that in practice the last two depositors (i.e. of saving and demand accounts) do not withdraw their funds all at once; instead they draw a small portion occasionally and much of it remains with the bank most of the time. The proportions of funds withdrawn from the banks by the depositors varies with different countries and is influenced by many factors, i.e. the economic habits of the people, political stability, industrial development, the use of cheques and the general creditability of the banking system, etc.

The Islamic bank, like any modern bank, will use a considerable part of its total deposits in investment on a profit-sharing basis and not on interest. It will invest these funds in short-term industrial , commercial and other profitable but secure enterprises, on profit-sharing basis. It is desirable that these funds are invested mainly on a short-term basis, preferably in industrial shares as this will enable the bank to earn profit without blocking its capital for a longer period (because the industrial shares are like ready cash and can be sold on the market at any time). This is cautionary advice to the bank about the use of its funds deposited in savings and demand accounts.

bank's main business however is concerned with the investment of the deposits on a profit-sharing basis and the deposits under discussion are motivated by 'precautionary motive' and transaction motive or keeping motive. The depositors of these funds, especially the demand depositors, intend to utilise them and are, therefore , not interested in profits on them. They also do not expect any return or income from deposits. It is, therefore, logical and reasonable to expect that the bank not utilise these funds, at least a major portion of it, in long-term investment projects for making profit. But it is desirable that a major portion it is used by the bank in meeting the short-term loan requirements of its customers free of charge.

case of funds under a savings account is slightly different from this category of deposits. These deposits are motivated primarily by 'precautionary motive,' but their secondary motive may be the 'earning of profit'. The bank can safely invest a reasonable portion of these funds in long-term investment on a profit-sharing basis, but, again, it will be desirable that some portion of it is invested in buying short-term industrial shares which will enable the bank to keep some of its resources in liquidity form. However, it is for each bank to decide how much of its capital is to be kept in liquidity form, and how much is to be invested for earning profit. In as far as funds under savings account and demand account are concerned a safe ratio will be determined by experience of the Islamic banks over a period of time

case of time depositors is comparatively simple. They are chiefly interested in earning profit from their saving and the bank can very easily invest a major portion of these funds in long-term investment projects and keep a small portion to meet their demand for cash

3. Investment

The bank invests its capital either through ***Shirkat*** (unlimited partnership) or *Mudarabah* (limited partnership).

Since the main source of its revenue is derived from its share in the profits of these partnerships it is desirable and necessary that it should diversify the

investment of its funds to ensure a regular income from its ventures.

(a) *Shirkat Ainan* (Unlimited Partnership)

The bank may invest its capital on the principle of unlimited partnership. As such, it will sign a contract of partnership with the enterpriser and actively participate with him in the management of the enterprise in order to safeguard its interests. However the option of active participation in the business under this type of partnership is open to the bank at all times.

In this case if both the parties have made equal contributions to the working capital of the business, they will equally share the profit (as well as loss), of the business. For example, if the bank and its partner decided to invest £100,000 in business, each contributing £50,000 and the business has yielded a net profit of £20,000 during the first year, each will receive a net profit of £10,000 from it. And in case of a loss of £5,000 during the first year, each will pay £2,500 to the partnership to enable it to carry on its work.

If the capital contributions are unequal, the share of the partners will be unequal, each receiving his share of the profit in proportion to his capital. For example, if the two partners have invested £100,000 in a business, the bank contributing £75,000 and the other £25,000 and the annual profit has come to £10,000, bank will receive £7,500 (three-quarters) of the profit, while its partner will get £2,500 (one-quarters).

If the bank compels its partner to give it a greater share of the profit out of its proportion to their respective contributions, the partner may refuse to enter into *Shirkat* with it prefering instead to take capital on limited partnership *(Mudarabah)* with it or any other bank and share the profit according to mutually agreed terms – pay it one-quarter, or one-third of the profit, or even less. It is , therefore, in the interest of the bank to agree to share the profit on reasonable terms and not to compel its partner to agree otherwise.

In fact, *Shirkat* partnership is suitable for the bank only when it is the active participant in the business, which, for the bank is unpracticable and very

expensive. The bank will, however, make sure that its liability is limited to the amount of its invested capital in the business in order to safeguard the interests of its depositors. The best and most appropriate and desirable form of partnership for the bank is *Mudarabah* (limited partnership).

(b) *Mudarabah* (Limited Partnership)

The main banking function of the Islamic bank is to give its capital to individual businessmen or firms on the principle of *Mudarabah*. Both the bank and its partner share in the profit (but not in the loss which falls on the bank) in mutually agreed terms which are clearly stated in the contract of *Mudarabah'* The bank neither participates nor interferes in the day-to-day business of its partner. It may, however, ensure at the time of contract that its capital is not invested in any ***haram***, ***makruh***, or unsafe enterprise. It may also, if it desires, take a written guarantee from its partner as a part of the contract that its capital will be invested only in certain specified profitable trades or industries.

The bank has the right to check the accounts of its partner and its business operations at any time it likes in order to ensure that the conditions of the contract are fully adhered to by him. Whenever it finds that any clause of the terms and conditions of the contract is not fully observed by the partner or partners, it has the right to terminate the contract unilaterally by giving reasonable notice to the other party. The profit is shared by the partners as fixed in the contract of partnership, but the bank is free to re-negotiate its percentage at any time it likes. (It must be remembered that the shares of the partners in business must be fixed as percentage or ratio of the profit and not a specified amount of it; for example, 40% or 2/5 of the profit for the bank and 60% or 3/5 for the partner, but not £5,000 or any other specific amount for the bank or its partner). The bank will in consultation with its partners, fix the percentage or ratio of profit of each partner according to the amount of his capital or independent of it. It may also fix different percentages or ratios of profit with different partners at the time of the contract.

4. Financial Assistance to Industry in General

The bank will do its utmost to assist in the industrial development of the

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4. Financial Assistance to Industry in General

The bank will do its utmost to assist in the industrial development of the

country by providing all kinds of financial help (i.e. short, medium and long-term loans) to industry. It will take all possible measures to ensure that the required funds are readily available to genuine applicants. The bank will, however, make sure that the industry concerned is viable and likely to make a profit. Like the modern banks, it will satisfy itself before advancing loans that the party is financially and business-wise sound and trustworthy in order to ensure the safety of its funds. To ensure the safety of its funds, it will, like the modern banks, satisfy itself before making any advance that from a financial and business point of view the party is sound and trustworthy. It will investigate the industry thoroughly, and only after receiving a satisfactory report from its experts will advance the loan.

The profit (or loss) will be shared by the parties in accordance with the following pronciples clearly laid down in the contract: (1) Industrial practices of the country; (2) Amount of working capital of each partner; and (3) Duration of the loan. All matters relating to the amount , time or manner of payment of the profit (or loss) and other relevant problems will be settled between the partners by mutual agreement according to the terms and conditions of the contract. The bank will provide working capital for long-term expansion or improvement of industry and will become its owner to the extent of the proportion of its capital to the total capital of the industry.

5. Loans for Trade and Commerce

The bank will advance loans to individual traders as well firms on the same basis of *Mudarabah*. A partnership contract, stating the amount and duration of capital, the terms and conditons of the contract, and the respective share of each partner (as a percentage or proportion) in the profit (or loss), and other relevant matters, will be signed between the parties. The partnership, in general, will be based on the principles explained above under the organisation of the Islamic Bank.

6. Loan for Agriculture

The bank will provide financail assistance to agriculture for permanent improvements in land on the basis of *Mudarabah*. The bank will enjoy the right of ownership of the land to the extent of the value of its capital in proportion

the total value of land assets until the loan is returned. The partnership ween the bank and the farmer is discussed under the organisation of the Bank.

Other Functions of the Bank

bank will also perform all those functions which are normally done by dern banks, but it will not charge any interest from any of its client. It will in the transfer of funds from one place to another on reasonable mission. It will keep custody of jewellery and other valuables of its clients. will accept bills of exchange either on reasonable commission or just as antee for the payment of a loan. The bills of exchange will be accepted like inary cheques without any interest by the bank but these must be cashed at proper date because under no circumstances in the interest-free economy, they be allowed to remain in circulation after the expiry of their period. will help and encourage the successful and healthy circulation of bills of nge, like ordinary cheques, without the involvement of the element of rest and will provide stimulus to profitable and successful industries.

bank will also help and encourage various industries by buying their shares the open market. This will increase industrial production and at the same provide the bank with some income from the profits of industry. In ition, a number of personal services will also be provided by the bank to its tomers, such as safe deposit and foreign exchange facilities, the issue of veller's cheques, executor and trustee business all of which will be done on sonable commission like modern banks.

Investment in other Companies Shares

very useful means of investment for the commercial banks is to buy Government industrial shares and the shares of successful industrial and mmercial companies. In modern times, all banks and financial institutions vest a portion of their capital in the purchase of such shares. They are bought sold in the open market like any other commodity. The holders of such ares are the owners of the company in proportion to the value of their shares accordingly receive profits annually or bi-annually on them.

The buying and selling of shares with suitable modifications can be maintained in the Muslim economy. All kinds of mal-practices of the modern stock markets, espically the speculative buying and selling of shares, will be forbidden by law. All shareswhich carry a guarantee of minimum profit, or are given special interest treatment will also be declared illegal. There is every likelihood that, after such measures, the market for common stock will develop and grow on healthy lines and the price of all shares will be determined in the open market by the actual profit-earning capacity of their respective companies. This will guard the Muslim economy from the scourage of the modern stock exchange with speculative buying and selling and thereby keep it free from the evils of trade cycles, the offspring of the interest-ridden economy of the western World.

The best way for the Islamic bank to earn some profits from its liquid funds and maintain their liquidity as well, will be to buy Government industrial shares and shares of different industrial and commercial firms. This diversification of investment will ensure an over-all profit at all times. If there is a loss or no profit on some shares, it will be neutralised by profits on others. It is always the best policy to spread out investment by buying various types of shares in the market to avoid the risk of loss.

The purchase of shares has another advantage for the bank: it will help the bank to maintain its liquidity ratio at a reasonable level at all times, because it can sell these shares in the market whenever it wishes to meet its financial commitments. In fact, the bank's stock of shares is equivalent to hard cash or liquid money because it can be sold at any time for cash.

8

Short – term Loans

Introduction

The bank will advance all kind of short-term loans free of interest to industry, agriculture, trade and commerce. It will neither charge any interest nor demand any reward or compensation in return as profit on such loans. These loans will be considered goodly loans (Qard-al-Hasna) on behalf of the bank to help industry, agriculture and trade during difficult periods. Industrialists and traders often require short-term loans during the period when their goods are being sold and they may fall short of cash. Agriculturists also find themselves in great hardship during the harvest season and when they are marketing their crops for sale to various trading centres. Short-term loans can be very helpful to these people to tide over short difficult periods, and once these periods have passed the loans can be returned without causing any financial embarrassment to the bank.

It would be very difficult, indeed impossible, for such people to get short-term loans on *Mudarabah* in an interest-free economy, owing to the difficulty in calculating profit for short periods of one to three months. But loans can be secured easily without much difficulty from the commercial banks on interest under modern banking system. It is, therefore, desirable and necessary that the Islamic bank should provide such interest-free loans to industry, trade and agriculture during their difficult periods. Such funds can conveniently be made available to these people from the current account deposits. It is quite in order that the Islamic bank should keep a fixed Reserve Fund from these deposits for this purpose. As the bank pays nothing to these depositors, it can very easily loan some of these funds to industry, trade and agriculture to tide over difficult periods. Before it can advance such loans, however, the bank may require some creditable guarantee from the debtors to ensure the payment of the loan.

After keeping a normal reserve against demand deposits, to meet its clients'

demand for cash, the bank will set aside a certain amount of the remaining demand deposit to make short-term interest-free loans to businessmen under the instructions of the Islamic Central Bank, and will invest the remainder partly in buying shares and partly in *Mudarabah* partnership in some profitable enterprises.

The reason for treating short-term loans in this manner is that their investment on a profit-sharing basis is neither practical nor suitable, especially when they are advanced to meet urgent and temporary needs of businessmen. It would be very difficult, if not impossible, to prepare profit or loss accounts for funds advanced for very short duration, i.e. less than three months. As these loans are normally of self-liquidating nature, the bank would not find it difficult to arrange them out of the credit reserved for such loans. In addition, the bank can also make overdraft facilities to its depositors and short-term accommodation to the Government from this fund .

In case of short-term loans of longer duration, (from three months to 24 months), the bank may advance such loans on the basis of profit-sharing, especially for one year or two year loan because it would not present any difficulty to prepare profit or loss accounts for such periods. Beside, these periods are sufficiently long to warrant a share of the profit or loss from the businessmen who have used these funds.

As will be explained later, the bank would be quite willing to give such loans free of interest (قرضاً حسناً) to businessmen for a number of reasons. The Islamic Central Bank usually offers facilities of re-fianance against all interest-free loans advanced by the bank and also the use of the other portion of demand deposits in profitable businesses on profit-sharing basis. It may withdraw such facilities in case of non-compliance with this condition of making interest-free loans. Above all, the granting of such short-term loans will greatly increase the bank's creditability and reputation in the eyes of businessmen receiving interst-free loans. And there is every likelihood that with the increase in their profitability, the bank's share of the profits will also go up.

The bank will provide short-term loans to industry for buying raw-materials or

wages etc., to its working force and for meeting other similar situations. short-term loans may range between one month and one yearr as ined below:–

One-Year Loans

industrialists may need cash for various purposes for a period of one . This period is long enough to determine the profitability of the rowed capital as well as the share of each partner. The bank can very easily one year loans on a profit-sharing basis and, at the end of the year, share profit (or loss) with its partner. Under certain circumstances, the bank give such loans as goodly loans (as *Qard al Hasna)* to the hard-pressed ors, if the Reserve Fund from the Current Account Deposits is fairly ng.

bank can advance one-year loans to farmers in need of loans of such tion, but it is desirable and appropriate that these loans are always given as odly loans (i.e. as *Qard al Hasna)* from the Reserve Fund of Current Account posits.

(b) Half Year or Quarter-Year Loans

There will be many individual industrialists and firms who will need funds for half-yearly or quarter-yearly periods for various reasons and will have to borrow money to meet their short-term requirements. Their likely half or quarter-year rate of profit can be determined from their annual rate of profit, which the bank can also use to determine the earnings for a shorter period, say of three or six months, if it is not possible to determine the actual earnings on any particular amount of borrowed capital during these short periods.

Thus, the bank will be in a position to grant even these short-period loans on a profit-sharing basis; but it will be desirable and preferrable for the bank to give all such short-term loans free of interest (as *Qard al Hasna)* from its Reserve Fund out of the Current Account Deposits on which it pays nothing to its depositors. Since the bank receives these deposits without making any payment, it seems quite right, that it should help industry, trade and agriculture with short-term loans without any charge. The bank is always

demand for cash, the bank will set aside a certain amount of the remaining demand deposit to make short-term interest-free loans to businessmen under the instructions of the Islamic Central Bank, and will invest the remainder partly in buying shares and partly in *Mudarabah* partnership in some profitable enterprises.

The reason for treating short-term loans in this manner is that their investment on a profit-sharing basis is neither practical nor suitable, especially when they are advanced to meet urgent and temporary needs of businessmen. It would be very difficult, if not impossible, to prepare profit or loss accounts for funds advanced for very short duration, i.e. less than three months. As these loans are normally of self-liquidating nature, the bank would not find it difficult to arrange them out of the credit reserved for such loans. In addition, the bank can also make overdraft facilities to its depositors and short-term accommodation to the Government from this fund .

In case of short-term loans of longer duration, (from three months to 24 months), the bank may advance such loans on the basis of profit-sharing, especially for one year or two year loan because it would not present any difficulty to prepare profit or loss accounts for such periods. Beside, these periods are sufficiently long to warrant a share of the profit or loss from the businessmen who have used these funds.

As will be explained later, the bank would be quite willing to give such loans free of interest (قرضاً حسناً) to businessmen for a number of reasons. The Islamic Central Bank usually offers facilities of re-fianance against all interest-free loans advanced by the bank and also the use of the other portion of demand deposits in profitable businesses on profit-sharing basis. It may withdraw such facilities in case of non-compliance with this condition of making interest-free loans. Above all, the granting of such short-term loans will greatly increase the bank's creditability and reputation in the eyes of businessmen receiving interst-free loans. And there is every likelihood that with the increase in their profitability, the bank's share of the profits will also go up.

The bank will provide short-term loans to industry for buying raw-materials or

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One-Year Loans

industrialists may need cash for various purposes for a period of one This period is long enough to determine the profitability of the rowed capital as well as the share of each partner. The bank can very easily one year loans on a profit-sharing basis and, at the end of the year, share profit (or loss) with its partner. Under certain circumstances, the bank give such loans as goodly loans (as *Qard al Hasna)* to the hard-pressed tors, if the Reserve Fund from the Current Account Deposits is fairly ong.

bank can advance one-year loans to farmers in need of loans of such ation, but it is desirable and appropriate that these loans are always given as odly loans (i.e. as *Qard al Hasna)* from the Reserve Fund of Current Account posits.

(b) Half Year or Quarter-Year Loans

There will be many individual industrialists and firms who will need funds for half-yearly or quarter-yearly periods for various reasons and will have to borrow money to meet their short-term requirements. Their likely half or quarter-year rate of profit can be determined from their annual rate of profit, which the bank can also use to determine the earnings for a shorter period, say of three or six months, if it is not possible to determine the actual earnings on any particular amount of borrowed capital during these short periods.

Thus, the bank will be in a position to grant even these short-period loans on a profit-sharing basis; but it will be desirable and preferrable for the bank to give all such short-term loans free of interest (as *Qard al Hasna)* from its Reserve Fund out of the Current Account Deposits on which it pays nothing to its depositors. Since the bank receives these deposits without making any payment, it seems quite right, that it should help industry, trade and agriculture with short-term loans without any charge. The bank is always

expected to advance these half and quarter-year loans to agriculture free of charge from its Reserve Funds.

(c) One to two-month loans

The bank has absolutely no moral grounds to charge anything on these very short-term loans. It has considerable unused funds from the Current Account Deposit as well as from its Saving Account Deposit which can easily be used for meeting one to two-monthly loan requirements by industry, agriculture and trade without any need to charge.

Industry can easily secure these very short-term loans from the commercial banks on interest in the modern banking system, but it will not be possible for industry or agriculture to obtain them in an interest-free economy. It is, therefore, essential that all kinds of very short-term loans, ranging from one month to two months and in some cases even six month loans, must be granted by the Islamic bank from its Reserve Fund without any charge.

(d) Less than one month loans

Many firms or individual businessmen may need cash for less than one month to improve or supplement their liquidity position. Any returns on such short period loans is out of the question. The amount of the loans under Sections (c) and (d) will be strictly limited and will only be given to those persons or firms in the most genuine need. The bank reserves, moreover, the right to make some charge from the borrowing parties to cover its costs.

Some critics misguidedly question the feasibility of short-term loans under two-tier *Mudarabah* banking. They argue that no short-term credit can be supppplied by the interest-free banks because the loan in the contract of *Mudarbah* is supposed to be a long-term loan. They emphasise that " such a loan is, by its nature, a long-term, for the contract of *Mudarabah* is to perform a transaction whose duration cannot be exactly determined." *Mudarbah* contract, according to them, is absolute and no time limit can be placed on it because the duration of the transaction in the *Mudarabah* contract cannot be exactly known; and the profit cannot be determined unless and until the

...saction is completed. Therefore they rule out the possibility of short-term ...in *Mudarabah* banking.

...when we analyse the arguments of these people, we find that there is ...ding in the nature of the contract of *Mudarabah* which negates the ...sibility of short-term loans. The problem of any time-limit with respect to ...t-term loans is prectically irrelevant because most of these loans, as already ...ntained, can be given to the various applicants out of the Reserve Fund from ...e Current Deposits without any charge or profit-sharing (as *Qard al Hasna).* ...in the case of one to two-year loans, any profit can very easily be ...culated either with reference to the actual earnings of that year or to the ...rage annual earnings of that firm or individual businessman, without ...nging the interest of either of the partners (i.e. the agent or the bank).

...nother objection is that the Islamic bank will not be able to advance loans to ...ch firms or businessmen whose capital is already invested in it; for it will be ...inst the principles of *Mudarabah*, the borrower being both the agent and ...cipal at the same time and in the same transaction. It is argued that this ...ntract will result in a conflict of interests on the grounds that as the ...rrower is the agent and principle at the same time, he will always work ...gainst the interest of the bank.

...e think that this argument of a ' conflict of interest ' is greatly exaggerated. ...f all possible legal safeguards are taken at the time of the contract between the ...nk and its agents, and reasonable security is obtained from the latter, there is ...o reason why this arrangement should not work smoothly for the benefit of ...oth the parties. No legal or moral objection seems to arise if a few ...djustments are made in the form and terms of the contract of *Mudarabah* to ...ake it work more efficiently and effectively to the advantage of both the ...rtners. As long as there is no legal barrier, we can always adopt *Mudarabah* ...with structual or organisational change without any fundamental alteration to ...s basic principles to meet our needs and requirements provided we do not ...nfringe any rules of *Shariah*. And there is no justification for calling such an ...rrangement ' deviation ' from the original necessitated by its ' failure and ...nefficiency ' , especially when we know that the so-called ' original ' was ...either based on the *Qur'an* nor *Sunnah* of the Holy Prophet, but was generally ...sed by the companions of the Prophet as a useful and beneficial form

of business.

Thus, we find no real trouble in advancing short-term loans of various durations from the Reserve Fund kept from the Current Deposits for this purpose. The bank can fix a Reserve Ratio, say of 25% of the Reserve Fund specially reserved for short-term loans (as *Qard al Hasna*) without any charge and these will be given to deserving applicants after they have been thoroughly scrutinised by the bank.

Allocation of Short-term Loans

There is no doubt that the allocation of short-term interest-free loans will present some problem of adjusting the limited supply of funds to the demand made upon them, but we hope it can be solved without much difficulty. To start with, much of the demand for call money and short-term credit, which comes from within the financial sector, will be greatly reduced due to the decline in the size of this sector after the abolition of interest.

The normal demand for short-term loans may be estimated with reference to the volume of long-term investments and the extent of trade credit (credit mutually given by one firm to another) and then the loanable funds available may be allocated by the banks among borrowers on the basis of the following principles:– (1)

(a) Specific credit needs of a firm.
(b) Social priority of any enterprise.
(c) Nature of security offered against loan.
(d) Whether the applicant has also obtained long-term advances from the bank for the same enterprise.
(e) Annual, monthly or weekly average of the applicant's balance in current account with the bank.

Average balances in the current account of an applicant in the bank should provide a reasonable basis for providing overdraft facilities to its clients and

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1. Dr. Siddiqui, M.N., paper read at the Economic Conference organised by the Islamic Council of Europe in London in April,1977.

...ould prove a very effective, successful and popular form of short-term ...free of interest. If is also desirable that bills of exchange of short ...ion (i.e., of about three months or less), should be accepted without any ...e, even though the rate of profit for three months on the capital involved ...be calculated. This step will greatly facilitate and stimulate trade and ...ness transactions inside and outside the country.

...y said that the availability of interest-free loans will create an artificial ...nd for loanable funds because inefficient businessmen will enter into the ...ket merely to get such loans. As such, demand will far exceed the supply ...loanable funds and the bank will find it difficult to distinguish between a ...icious and a genuine and deserving borrower.

...but this is not a strong argument against short-term interest-free loans for the ...k will not find much difficulty in distributing its loanable funds among ...serving borrowers as already explained. Every Tom and Harry will not be ...le to obtain these loans because bank will judge the needs of the borrowers ...m their long-term capital investments which are the determinants of the ...ort-term requirements of the industry. Besides, the bank will have the option ...o give preference to its own clients.

...f the bank still finds that there is an excess of demand over supply of loanable ...nds in the market, it may, if it thinks fit, lower the margin of such ...ccommodation and apply " more strict standards in assessing needs and ...ccepting securities ." Besides, the quality of the security offered and the ...redit-worthiness of the borrower concerned will also help in decreasing the ...ffective demand for loanable funds." If there is persistent disparity between ...demand and supply, " the Islamic Central Bank may consider revising its ...ending ratio – " the ratio of loanable funds to the total demand (1)

Though there will not be any interest charge on these loans, the bank may, however, realise its service charge in the form of a fee per application for the loan. (1)

Consumer Credit (i.e. Personal Loans)

Personal loans are given by modern banks in the Western countries for various purposes, but they all carry interest. The loans are usually repaid by the customers in small instalments . This method is very common in modern industrial countries of the West where banks issue credit cards to their clients. The amount of credit varies from £10 – to £200 – depending upon the position and creditability of the client. The banks charge a very high rate of interest on these loans.

Consumer credit, or credit for non-productive purposes, was generally needed in the past to meet unforeseeable circumstances, or acute personal difficulties, but, it has undergone a major change in the recent years. Firstly, it is no longer confined to the poor in the lower middle class but has become a normal habit of life among the middle and the upper middle classes. Secondly, the object of consumer credit is not to meet the needs of the people under abnormal conditions, but to assist in raising their standard of living through the purchase of durable consumer goods, including furniture, television, washing machines and even houses, etc. This higher demand for credit on the part of consumers is the direct result of a planned campaign through radio, television and other means of publicity by the producers and sellers of these goods.

" The created demand for the newly developed durable consumer items has tempted the people of the middle class to raise their standard of living in advance of higher income expected in future, or sometimes even without this expectation. In the latter cases, the repayment is made out of the wages (or salaries) of the people over a period of time." (2)

. Under Modern Economy

Consumer credit in the Western economies has expanded beyond measure and created many problems for the people as well as the Government. In order to encourage consumers to utilise the credit facilities made available to them by different means, the modern banks use all the means of publicity at their disposal. They issue brochures, leaflets etc. explaining the various types of loans and how to use them. The bank's loans application form answers all your questions.

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2. Dr. Muhammad Uzair, Paper read on " Intrest-Free Banking " at the First International Islamic Economic Conference 1976 – Makkah.

... the Banks Encourage Consumer Credit

... modern commercial banks adopt multifarious methods to encourage ..., especially housewives, to take different kinds of loans from them to ... their dailly needs of various sorts. Some of these methods are:–

... Bank Card

...ably the most widely known and commonly used service which has helped ...menting 'created demand' for a varieties of goods from all sections of the ...in the Western World, is the bankcard (e.g. Barclaycard, Midlandcard). It ... be used as both a credit card and a cheque guarantee card. Anyone over ... age of 18 may apply for one at any time, but normally the bank prefers to ... a new customer run his or her cheque account for six months before ...ering them a bankcard.

(b) Bankcard as a Creditcard

...bankcard can be used instead of cash or cheques to obtain goods or services ... to your credit limit wherever you see the '----------Bankcard Welcome ...here' sign. This means, in effect, that you can have an 'account' at thousands ... shops, garages, restaurants, hotels, main railway stations etc. throughout ... country. You just present the card, sign the sale voucher, and the sale is ...mplete. In all cases, you can settle the total of all your bankcard transactions ...within 25 days of the statement date, or if you wish, you can take advantage of ... bankcard extended facility. You then need pay only a proportion of the ...tal amount owed and spread the remaining cost to suit your personal ...budget. The bank will charge interest on the amount owed by you.

(c) Bankcard as a Cheque Guarantee Card

If you have a personal cheque account with any bank, it will enable you to use your bankcard to guarantee your cheques when settling a bill anywhere in your country. Only one cheque may be used for each transaction, and neither the transaction nor the cheque may exceed £30 in total. As a security measure, any cheque offered with your bankcard as a guarantee must be signed in the presence of the payee.

Provided you have a personal cheque account with any branch of a bank, you

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may obtain up to £30 cash a day by cheque at almost any branch of any bank in the country, using your bankcard as identification.

(d) As a Cash Advance

Without writing out a cheque, but by presenting your bankcard, you can obtain a cash advance of up to £30 on your bankcard account at any branch of that bank. This facility, however, is subject to the amount being available within your credit limit. A small service charge will be added to the amount of the advance, the total included in your next bankcard statement.

(e) Using Bankcard Abroad

You can use your bankcard as a credit card in over 100 countries. In addition, you can obtain cash at many European banks by guranteeing your cheque with your bankcard.

(f) Bank Loan

A bank loan is arranged directly between you and your bank manager. It can often be tailored to suit your particular needs. Repayments are usually in regular equal amounts with interest at the current rate, charged separately each half-year.

(g) Overdraft Facilities

You may need a little extra money to tide you over at the end of the month on many occasions and bank will often agree to give you an overdraft up to a certain limit. It allows you to withdraw up to your set limit without any further reference, provided you keep within your agreed limit and generally conduct your account in a satisfactory manner. You will, of course, incur interest charges on the amount you overdraw.

(h) Home Loans

You can use a Bank's home loan scheme for buying a new house or for making substantial improvements to your existing one. There is a flexible pattern of repayments covering a period of no more than eight years. In some cases, the loan interest is eligible for tax relief.

...there are scores of ways in which a bank may advance loans to its ...mers to buy durable goods and encourage its clients, especially ...wives, to spend beyond their means and thereby increase the 'created ...d' in the market. The banks launch extensive publicity campaigns to ...act as large a proportion of the population as possible on several occasions ...year to popularise their credit facilities among its consumers. The ...aigns actually reach every home in the country and finally succeed in ...ing over millions of customers.

...Under Muslim Economy

...don't think an Islamic bank will play a leading role in providing loans to ... consumers. However, as explained before, it may provide limited ...rdraft facilities to its demand depositors depending on their average ...thly or quarterly balances. It may also be willing to encash 'instalment ...chase' documents for its very reputable and credit-worthy depositors to a ...ited extent in the same way as it does in case of traders' bills of exchange. ...these loans facilities will be granted free of interest or profit. (2)

...Islamic bank will provide personal loans free of interest, but only to those ...sumers who have established their creditability with it. These loans may ...two forms: (a) Loans may be given to the customers as charity loans (as ...rd-al-Hasna) free of interst for short periods; (b) The loan may be given to ...goods of limited value on credit from specified shops.

...loans will, however, be repaid by the customers in easy instalments. The ...odern banks charge interest on the amount spent by the client but the ...lamic bank will not charge any interest. It may, however, charge a small fee ...r clerical and other expenses incurred by it. The bank may, for this purpose, ...pen a personal loan fund (i.e. consumer credit fund) from its deposits received ...der current account deposit, for which it pays no profit (or interest) to the ...depositors and may easily provide personal loans to consumers and ...non-consumers from this fund. To avoid any risk of loss in case of default, it ...will be quite in order for the bank to insure these loans on reasobable ...premiums with some Islamic Insurance Company if it can find one. However, ...the Islamic bank will not encourage the public to borrow personal loans for ...buying durable household goods, luxury articles, such as cars, television sets,

refrigerators, etc.

Since it is fitting that repayment of interest-free loans must in all cases be fully guaranteed, this guarantee must ultimately come from the state. This is because there is always possibility of default due to multifarious unforeseeable factors, including death, fire or bankruptcy. In all such cases, the state must guarantee the payment of the loan. In many genuine cases of default, the loan money could also be paid out of the *Zakat* Fund. (3)

In the Muslim economy, under the interest-free banking system, the problems of the lower and lower middle classes will be easily and effectively solved through the organisation of the co-operative banks and co-operative consumer societies. The people in the low income group who are employed in the Civil Service or in the private sector may also get some assistance from their employers to meet some of their needs. Employed people who have joined some contributory provident Fund or Pension Fund schemes, may find it easier to obtain such help from their employers to meet their consumer credit needs. The co-operative banks or co-operative consumer societies will be most suitable to meet the requirments of the self-employed and rural people in the agricultural sector. (3)

Aa for the 'created demand' for credit on the part of the middle and upper middle classes to raise their standard of living beyond their means – something which is being questioned by many sociologists and economists even in the Western countries– this will not be considered by the Islamic bank. However, their need for houses etc., can be met by the Housing Corporation or Co-operative Bank and any other genuine demands will be taken care of by the Commercial Bank through their interst-free loans, but the great majority of such people with 'created demands' will go without credit.

"The question is whether it is desirable to encourage people to live beyond their means in a race for raising the standard of living. From the socio-economic point of view, perhaps this may seem quite undesirable in any society, including the high consumption societies of the West. Many sociologists and economists are worried about this phenomenon in rich

3. Dr. Muhammad Uzari, op. cit.

While the sociologists are concerned about the desirability of 'living one's means', the economists are concerned about the excessive credit and susceptibility of the economy to the cyclical fluctuations.

a large extent, the genuine demand for cunsumer credit can be met by sources of borrowing such as specialised agencies sponsored by the ment or borrowing from the employers, in the case of employed Self-employed people can use the facilities of the specialised housing in the Government or in the private sector.

There will be thus a process of elimination and only a residual demand for credit will fall upon the '*Mudarabah* Banks'. Interest-free loans can made available by these banks for 'the limited and genuine needs of the ers out of the demand account and saving account deposits,. All these resulting from 'residual demand' will, however, be decided on the of each of them and what then can be done about these will depend on availability of funds for this purpose."(3)

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9

Bank Reserves and Bank Credit

Reserves

Like any modern bank, the bank will receive deposits in *Mudarabah* savings and demand accounts from the public and will maintain Reserve Ratios (Reserve Funds) to honour its various commitments in an interest-free society. For this purpose it will keep three separate Reserves (Reserve Funds)

(a) Banking Reserve Fund

The bank will keep fractional reserve against its total deposits, including savings and demand deposits, to meet the daily cash requirements of the depositors. A portion of this banking reserve will be kept with the Islamic Central Bank as in the case with (the modern commercial banks and the central bank) and the remaining part will remain with the bank to enable it to honour all cheques from depositors of demand or savings accounts as well as to make payments, if any, to *Mudarabah* depositors for the withdrawal of certain funds with mutual agreement before the completion of the accounts period. For example, if the banking reserve is 15 per cent and the bank is required to keep half of this reserve with the Islamic Central Bank, it will be left with 7½ per cent of the total deposits as banking reserve to meet all cash demand from its depositors. However, this reserve along with daily deposits in demand and savings accounts, will normally be sufficient to enable the bank to honour its day-to-day commitments to its depositors. Any remaining funds, among these reserves will be used by the bank in making *Mudarabah* loans, buying common stock and rendering income yielding services to its clients.

(b) *Mudarabah* Reserve Fund

In general, the success of a bank, depends largely on its working efficiency and business reputation; greater its efficiency and trustworthiness, the larger will be its business; and as its reputation grows it will attract more and more customers. But the basic factor which determines the extent of the business

...s of a *Mudarabah* bank is the amount of profits it earns and distributes ...g its depositors. The ultimate success of a bank lies in attracting savings ...s deposits, especially *Mudarabah* deposits, and the expansion of its ...ess depends greatly on the scale of profits it distributes among its ...sitors. If its performance is encouraging and people receive a large share of ...s at the end of each account period, its reputation as a business partner ...grow and funds will start pouring into its *Mudarabah* deposits in millions ...there will certainly be no shortage of money for investment purposes.

...ough the bank must always take great care in selecting good and reliable ...arabah partners for its investment purposes it must also in order to avoid ...s as well as wide fluctuations in the rate of profits, build up a *'Mudarabah* ...rve Fund' for the benefit of its shareholders and *Mudarabah* depositors. ...s can be done by retaining a portion (or percentage) of annual, bi-annual or ...rterly profits from *Mudarabah* investments for the *'Mudarabah* Reserve ...d'. This small annual contribution will accumulate over a number of years ...e a substantial fund and will ensure a regular payments of profits to the ...sitors and the shareholders, irrespective of the state of business in any ...icular year. Whenever there is a loss in business in any year, it will not be ...ed on to the depositors or to the shareholders but will be borne by the ...k and the depositors and the shareholders will be paid their normal share ...profits from the *'Mudarabah* Reserve Fund'.

...this way, the bank may continue paying regular profits at the standard rates ...ually, bi-annually or quarterly to its depositors as well as shareholders. ...re will be no difficulty in calculating the standard rate on the basis of the ...t few years rate of profit or any revised rate of profits. In this way, the bank ...ll build up its reputation as a reliable and good investment proposition and ...ll strengthen its position as a sound business partner.

...) Demand Reserve Fund

...e bank will accept demand (i.e. current) deposits from the public without ...aking any payment. It will, however, provide the demand depositors with all ...e facilities that are available to them under the modern banking system, i.e. it ...ll give them cheque book facilities and meet their occasional cash demands. ...e the bank accepts these deposits, free of charge and at no cost to itself, the

Islamic central Bank would require it to keep a certain percentage of the demand deposits as reserve for making interest-free loans of short duration. The remaining funds can be utilised by the bank in various ways to increase its reserves, e.g. by ***Mudarabah*** partnership, purchase of common stock or by providing various other services to its clients.

For example, if the Islamic Central Bank requires the bank to keep 40% of its total deposits for making short-term iinterest-free loans to industry, trade, etc. then, after deducting 15% for the Banking Reserve Fund, it can use the remaining 45% of these deposits in profit sharing investments or in other revenue yielding projects, as it may please. It is quite right that the bank should be required to set apart a certain percentage, in this case 40% of its cost-free demand deposits, for advancing interest-free loans.

This enables it to meet the often pressing but temporary cash demands of trade, agriculture and industry – all vitally important social activities – free of interest, since these deposits are maintained by the bank cost-free from its demand deposit accounts. As already stated the bank is free to use the remainder of the deposits from these accounts (in this case 45 percent) for investment purposes from which it can earn profits for itself without sharing them with anyone else (i.e. by buying shares or government securities) or in forming ***Mudarabah*** partnerships.

Bank Credit and Credit Creation

The privately owned commercial banks have tremendous powers of credit creation at their control in the modern banking system. Deposit money which is an important part of the money supply, is under the control of the commercial banks. The ability of the banks to create deposit money is based on the fact that bank deposits have only to be fractionally backed by cash or ready money. If all bank deposits had to be backed a hundred percent, banks would not have been able to create deposit money. If any customer deposited £500 in a bank, and the bank gave the customer £500 credit on his deposit account, but kept the £500 in its vault to 'back' the deposit no more money would be created. In fact, the bank need not keep a hundred percent reserves, for it can use greater part of the deposit of £500 in creating more deposit money.

1. Richard G. Lopsey, *An Introduction to Positive Economics*, London,

the creation of credit on a large scale against fractional reserves is the cause many economic evils, including inflation and speculation, we intend to cuss this matter in some detail, firstly, in modern banking system and condly under an interest-free banking system.

Credit Creation under the Modern Banking System

st let us assume that there is only one bank in the country (with as many nches as is necessary) in which some one makes a new deposit of £100 in sh. How this transaction will be recorded in the books of the bank is shown low:

Table 1

A new deposit is made

Assets	Liabilities
Cash £100	Deposit £100

he balance sheet will show new assets of £100 in the form of cash and new abilities of £100 in the form of the customer's deposit. This deposit, and all thers like it, is a liability of the bank, since the bank owes this money to the ustomer and must pay it to him whenever he demands it. Since there is only ne bank in the whole country, the bank can immediately create new deposits y some multiple of £100, depending on the legal reserve requirements of the ountry. Let us say that the law requires a 10 per cent reserve. The bank could mediately create further deposits of £900"(1) and make them at once vailable as loans to potential borrowers.

"How these transactions will appear on the bank's books once the borrower as written cheques to the allowable amount is shown under:

Table II

£900 is invested in loans with no cash drains

Assets	Liabilities
Cash £100 Loans £900	Deposits £1,000

The bank's assets include the £100 cash of the original deposit, the loan of £900 (it is an asset of the bank , since the borrowers owe their money to the bank and must repay it at some stated date). The bank's liabilities are now £1,000 in deposits, £100 to the account of the original depositor, £900 to the account of the persons who have received payment from the customer who borrowed from the bank. Note that by a few strokes of the pen, the bank has created £900 in deposit money. The customers of the bank are now able to spend £900 more than they could yesterday and no one else is forced to spend any less."

"If every customer pays by cheque, the bank can effect these payments merely by changing the accounts of individual customers; no cash ever leaves the bank and the total of the bank's deposit liabilities does not change."(1)

Similarly, if the bank receives another deposit of £1,000 in cash, it can immediately create £9,000 in deposit money and the banks' book will show the transaction like this:

Table III

9,000 is invested in loans

Assets	Liabilities
Cash £1,000 Loans £9,000	Deposits £10,000

And if it receives a third deposit of £10,000 in cash and it creates £90,000 in deposit money, the banks' books will show the transaction like this:

Table IV

£90,000 is invested in loans

Assets	Liabilities
Cash £10,000 Loans £90,000	£100,000

If there are many banks and many new deposits, the position will be quite different and the deposit money created by each bank will run into hundreds of millions of pounds. "For example, the community contains ten banks of equal size and each bank receives new deposits of £100 in cash. All banks go on expanding deposits without losing cash to each other until each bank has created £900 in additional deposits, so that, for each initial £100 cash deposit, there is now £1,000 in deposits backed by £100 in cash. Now each of the banks will have entries in its books similar to those shown in Table II." And the total entries of all ten banks will look like this:

Table V

£90,000 in invested in loans with no cash drains

Assets	Liabilities
Cash £1,000 Loans £90,000	Deposits £100,000

And if each of the ten banks receives a second deposit of £1,000 in cash, the total money created in deposits by the banks will be as shown below:

Table VI

£90,000 is invested in loans with no cash drains

Assets	Liabilities
Cash £10,000	Deposits £100,000
Loans £90,000	

Thus, deposit money continues increasing nine-fold with every new deposit in cash with each bank. Taken together, the total deposit money created by each new deposit in cash in each bank every day is enormous.

This, in short, is the story of the creation of deposit money. A saving deposit of a mere £100, with 10 per cent Reserve Ratio and no cash drain, will enable the bank to create £1,000 credit money. Credit worth £900 has been created by the bank without any real resources backing it and without any real demand for its utilisation in productive enterprises. The interest-ridden economy is a haven for the speculators who are greatly patronised by the banks:" The present system prompts the banks to patronise speculators, other financial intermediaries and the government who are ideal short-term borrowers. The ultimate investor figures in their portfolios only marginally and often indirectly. The usually lengthy chain of intermediaries between the ultimate savers and the ultimate investors is largely a product of the ease with which credit instruments can be created and handled, thanks to interest. They bear very little relation to the structure of production. To justify this proliferation of financial intermediaries, the credit instruments with reference to the variety of tastes regarding liquidity, risk, size of holding and the time period involved presumes a sanctity for these tastes which is highly doubtful. To a great extent, they are the product of high powered propaganda and psychological manipulation.

One is reminded of the sex industry justifying pornography and all that with reference to variety of human taste. As in sex and the family so in finance and economy, the society must have some norms more stable than shifting tastes exposed to manipulation by interested parties. With a switch over from interest to profit-sharing the creation of credit instruments will be sharply curtailed."

"Public debt has now assumed such proportions that its repayment is no longer considered a feasible proposition. The society must go on servicing these debts, in most of the cases. Side by side, there has been a phenomenal growth in consumer credit in the more advanced economies. Abolition of interest will make the provision of consumer credit mostly a welfare service organised by the state. There would also be a limited possibility of using Pension Funds and the like for providing such credit. Thus, curtailed to reasonable dimensions, it will cease to threaten the peace of homes and the composure of individuals as it dees today by creating worries and tensions."

"While there is every argument in favour of increasing individual efficiency and improving personal standard through the acquisition of durable consumer goods early in life in lieu of payment out of future income, this has to be done in a manner that does not involve the transfer of sizeable proportion of personal income to rentiers by way of interest on credit." (2)

(b) Credit Creation in Interest-Free Economy

A change over from an interest to a non-interest economy need not produce any drastic change in the concept of credit creation although the nature and volume of credit money may undergo considerable change. This is because the ability of banks to create credit money depends primarily on people's habit to deposit part of their money with banks and only secondarily within the limits imposed by the Reserve Ratio and the demand for business finance. "The bank's ability to create credit is independent of the terms on which it is extended, depending as it does on the habits of the public which keeps only part of its income in cash and deposits the rest with the banks. The institution of interest is neither a necessary nor a sufficient condition for the bank's ability to create credit." (2)

The first significant effect in respect to credit money will be that no interest will be paid to the bank for his credit creation activities. In the modern economy, as already stated, the banks are able to earn 100 per cent in interest by advancing ten times the original cash deposit, assuming the rate of interest to be 10 per cent per annum. This payment to the bank for its credit creating activities will disappear in the interest-free economy.

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Mudarabah loans will bring in returns as a percentage of profits to the banks out of the newly created wealth which they financed. In making these *Mudarabah* loans the bank, as supplier of capital will indirectly be exposed to the risks involed in productive enterprise. In this way the capital supplier will be brought closer to wealth productive activities. With passage of time, the ability of savings to earn additional income will be completely destroyed, because any income will depend on the creation of additional wealth through productive enterprise.

Thus, "In the absence of interest, and on the assumption that the banks as profit-seeking firms will not supply interest-free loans, bank advances would be made only for the purpose of productive enterprise. Credit would be created only to the extent there exists genuine possibilities of creating additional social wealth through productive enterprise. The financial resources that banks provide by way of credit will have to be more than fully matched by real resources awaiting mobilisation by entreperneurs. Credit created on the basis of profit-sharing would not be inflationary in the long run. Demand for profit-sharing advances will be limited to the extent of the available resources and banks ability to create credit will be called into action only to the extent of this demand, subject to the constraint imposed by profit expectations that satisfy the banks. Supply in this case would not be able to create its own demand as it does at present." (2)

In this way, in an interest-free economy, *Mudarabah* Loans (i.e. bank loans) will be given only for productive enterprise and credit money will be created by the banks to meet the genuine demand for creating additional wealth through productive enterprise with real resources. This type of credit money advanced on the principle of *Mudarabah* will not produce inflationary affects in the economy. Creation of credit by the banks will, no doubt, assist in finding out such possibilities, but their actual attainment will depend on the availability of productive opportunities in the community and the extent of participation in its fruits by the depositors.

Just, "Consider the situation consequent upon a switch over from interest to

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2. Dr. Siddiqui, M.N., Paper read at the International Economic Conference, in London, April 1977.

profit-sharing. Bank *Mudarabah* advances could still be a multiple of their saving deposits, but their returns accrue as a percentage of profits actually realised when these advances result in creation of additional social wealth. These returns are then shared by the banks with the depositors according to an agreed percentage. Accrual of profits on deposits in this case devolves on exposure to risks involved in productive enterprise. The magnitude of those profits is determined by market conditions and the two rates pf profit-sharing which are subject to the forces of demand and supply. The power of real savings to acquire additional resources with the mere passage of time is completely destroyed. Instead, they have the possibility of acquiring additional resources to the extent their ultilisation in productive enterprise actually results in the creation of additional wealth."

"Creation of credit by the banks, has, no doubt, broadened these possibilities, but their actual realisation depends on the extent of production possibilities available. The social connection that allows the creation of credit is harnessed into action to the extent the production possibilities available with the society call for it, and its benefits are then passed to parties participating in the fulfillment of this social need at the risk of loss; of their real savings (depositors); or of the reward of services rendered as agents and intermediaries (banks); or of reward for entrepreneurial services (firms)" (2).

It will put a brake on inflationary tendencies which tend to break the backbone of modern economies because the volume of public debt and credit instruments will be considerably reduced and the size of bank credit greatly curtailed. All unhealthy forms of speculative activities will be forbidden which, coupled with the abolition of interest, will totally eliminate business cycles from the economy.

On the whole, the volume of bank credit will continue fluctuating with changes in the bank's cash reserves owing to the policies of the Islamic Central Bank or to changes in the cash demands of the public. And the credit creation policies or activities of the banks will also continue operating unaffected by the change from interest to share in profits, both for the depositors and the banks. (2)

10

SOURCES OF CAPITAL AND DIVISION OF PROFITS

Sources of Capital

As already explained (see chapter six and seven) the main sources of the bank's capital will consist of three principal types of deposits together with the profit derived from their investment.

If it needs more funds, for banking purposes or investment, it can, like any modern bank, borrow money from other banks, financial institutions, or the Government. It can also raise such loans from the public or the Government for fixed periods. The bank does not pay any profit to its creditors and repayment is guaranteed under all circumstances; no matter what the financial state of the bank

Loan capital can also be invested along with *Mudarabah* or *Shirkat* capital and included while calculating the percentage rate of profit on its total investment capital, but excluded from the dividion of profits. The whole of the profits on loan capital will go to the shareholders who are responsible for the return of this capital. If there is a loss in business, the entire loss on the loan capital will be borne by the shareholders and the *Mudarabah* depositors are not liable to pay any part. The shareholders, therefore, are entitled to have the full share of profit on loan capital plus their share on *Mudarabah* or *Shirkat* capital.

Mudarabah bank will definitely prefer this method of raising capital to that of issuing bonds or debentures on fixed interest unlike the modern banks and other companies. It seems to be a more effective and desirable way of collecting capital for investment, especially for short periods without any risk of loss to the creditors.

A further source of capital can be the sale of its bills of exchange, share certificates and Government-owned *Mudarabah* and *Shirkat* shares on the open market. As explained earlier, every *Mudarabah* bank is required to keep a certain part of its Demand and Savings deposits in cash or ready cash to enable it to meet the daily cash needs of the public. Bills of exchange and various share certificates form a resonable asset for the bank to keep in almost ready cash which could easily be cashed by selling them on the open market.

Division of Profits

The *Mudarabah* bank serves as an intermediary between the suppliers of capital (proprietors or *Mudaribs)* and users of capital (enterpreneurs, *Darib).* It collects funds from the former who agree to share the profits and losses with the bank in proportion to their capital. Then the bank advances capital on the basis of profit sharing to the entrepreneur or entrepreneurs. Thus, the *Mudarabah* bank acts as banker-depositor to one party and banker-businessman to another on thc basis of partnership.

In order to determine the profit per £100 or per share of capital, it will be necessary to calculate the total *Mudarabah* capital received from *Mudarabah* depositors and shareholders and capital from demand or savings account used for investment purposes (less capital reserved for short-term interest-free loans) will also be calculated. Then the total profit out of all the bank business will be calculated and after being divided by the total capital, it will give the percentage amount of profit.

The distribution of profits (or loss) in these two tiers of partnership will take this form:–

(a) **Bank-Businessman**

The *Mudarabah* bank will advance loans to various businessmen or business firms on the basis of partnership and this principle will not be affected by the composition of the investment capital. Whatever the capital with which the businessman is working whether it is capital supplied by the *Mudarabah* bank; or *Mudarabah* capital and with some of his own; *Mudarabah* capital, his own capital and some borrowed capital, or with *Mudarabah* capital and also some

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borrowed capital on a *mudarabah* basis from another *Mudarabah* bank – none of this will in any way affect or change the basic rule of *Mudarabah* partnership: that the profit will be shared by the partners on mutually agreed terms (percentage or proportion). In the bank-business tier partnership, the liability for losses falls only on the *Mudarabah* bank and the entrepreneur bears no part of them.

The division of the profit between the partners depends upon the contribution of each to the total working capital. In general, the greater the share in the capital of any partner, the higher will be the percentage or ratio of his profit. If the business partner of the bank is working only with the capital of the bank, then the profit will more or less be equally divided between them, the partner perhaps receiving a little more. The bank may receive 50% (or 1/2) of the total net profit and its partner 50% (or 1/2) or any other percentage or ratio agreed between them at the time of the contract.

Let us assume that they have agreed to share the profit equally between them. In that case the bank will receive half the profit of the business for its capital and business enterpriser, half for its labour, managerial skill etc. For example, if a businessman or a business firm has borrowed £50,000 *Mudarabah* capital from the bank and invested it in business and made £5,000 net profit at the end of the year, then each partner, the bank and business partner, will receive £2,500 in profit. And in case of a loss of £5,000, the bank will have to bear the total amount.

If bank's partner has invested £100,000 of which £50,000 is *Mudarabah* capital the remaining £50,000 belongs to the partner (either from personal saving or is borrowed from other sources) and the business has made £10,000 net profit at the end of the year the bank will receive £2,500 on the basis of the *Mudarabah* contract according to its share of the capital, while its partner will receive £7,500 i.e., £2,500 profit from *Mudarabah* capital and £5,000 on his own capital.

In the case of a loss of £10,000, the bank will lose £5,000, its share of the total loss on the *Mudarabah* capital, and its partner £5,000 on his personal capital. The bank will not be held responsible for the total loss of the business,

it will pay at the most, £5,000 out of a total loss of £10,000, in proportion to its share of the total working capital of the business. Likewise, its partner will pay at the most, £5,000 out of a loss of £10,000, in proportion to his personal share of the total working capital of the business. Thus, for all practical purposes, the liability of the bank on its *Mudarabah* capital invested through individual businessmen or firms will be limited.

Let us now assume that the shares of the parties are unequal, the bank receiving 40% (or 2/5) and its partner 60% (3/5) of the total net profit. For example, if the bank invests £50,000 with a partner on *Mudarabah*, who has no capital of his own, and makes a net profit of £10,000 at the end of the year, the bank will receive £4,000 of the profit and its partner £6,000. Again in case of a loss of £10,000, the entire loss will fall on the bank and the partner will not bear any part of it. Again, using the same percentages, if the total working capital of the business in £100,000 of which £50,000 is *Mudarabah* capital of the bank, £50,000 the personal capital of its partner, and the net profit at the end of the year comes to £20,000; then the bank will receive £4,000 as its share of the profit on its capital, while its partner will receive a total profit of £16,000 (i.e., £6,000 as his share of profit from the *Mudarabah* capital of £50,000, and £10,000 on his personal capital of £50,000). In the case of loss of £20,000, the bank will lose £10,000, its share of loss on its capital of £50,000 and its partner, £10,000 on his personal capital of £50,000.

And in the case of neither profit nor loss, neither party will get anything. Each will be entitled to its capital, if he wants to leave the business at the end of the accounting period. If the entrepreneur did not invest any of his own or borrowed capital, and used only the *Mudarabah* capital of the bank, he will get nothing and the capital will be returned to the bank, if they decide to close the business. But if they want to carry on their business partnership it will continue without any interruption.

This principle will apply to all forms of business, old or new, when ever capital is invested on the basis of *Mudarabah*. It is, however, essential that a standard procedure is adopted to calculate the total value of the old and established business, including machinery, equipment, buildings, finished and unfinished goods etc. All this must be taken into account at the same time of estimating the total value of the business, so that any profit (or loss) can accurately and

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Let us now assume that the shares of the parties are unequal, the bank receiving 40% (or 2/5) and its partner 60% (3/5) of the total net profit. For example, if the bank invests £50,000 with a partner on *Mudarabah*, who has no capital of his own, and makes a net profit of £10,000 at the end of the year, the bank will receive £4,000 of the profit and its partner £6,000. Again in case of a loss of £10,000, the entire loss will fall on the bank and the partner will not bear any part of it. Again, using the same percentages, if the total working capital of the business in £100,000 of which £50,000 is *Mudarabah* capital of the bank, £50,000 the personal capital of its partner, and the net profit at the end of the year comes to £20,000; then the bank will receive £4,000 as its share of the profit on its capital, while its partner will receive a total profit of £16,000 (i.e., £6,000 as his share of profit from the *Mudarabah* capital of £50,000, and £10,000 on his personal capital of £50,000). In the case of loss of £20,000, the bank will lose £10,000, its share of loss on its capital of £50,000 and its partner, £10,000 on his personal capital of £50,000.

And in the case of neither profit nor loss, neither party will get anything. Each will be entitled to its capital, if he wants to leave the business at the end of the accounting period. If the entrepreneur did not invest any of his own or borrowed capital, and used only the *Mudarabah* capital of the bank, he will get nothing and the capital will be returned to the bank, if they decide to close the business. But if they want to carry on their business partnership it will continue without any interruption.

This principle will apply to all forms of business, old or new, when ever capital is invested on the basis of *Mudarabah*. It is, however, essential that a standard procedure is adopted to calculate the total value of the old and established business, including machinery, equipment, buildings, finished and unfinished goods etc. All this must be taken into account at the same time of estimating the total value of the business, so that any profit (or loss) can accurately and

fairy be divided between the partners. This will greatly help to settle impartially important issues between them thereby keeping partnership free from any disputes arising out of misunderstanding and uncertaintly.

Another matter worth considering is the length of the contract. In certain industries, like farming or commerce, the whole business is completed within a specified period and it is therefore easy and convenient to calculate the total cost of investment as well as profit (or loss) in cash at the end of that period. In such industries, capital costs can be determined for the specified period and net profit (or loss) calculated and shared between the partners without much difficulty. But in the modern industrial world, the business is continuous and capital costs cannot so easily be calculated in cash without much loss to either of the partners.

In these circumstances, the bank's best method of investment will be to advance loans on ***Mudarabah*** either for a specified period, (and this must be a fairly long period, say five to ten years) or an unspecified period while keeping the option open to claim back its capital whenever its partner is not adhering to any of the conditions or terms of the contract, by giving reasonable notice to the other party. At the end of the period, or when the bank has claimed its capital owing to the infringement of any of the conditions or terms of the contract, the invested capital and the amount of net profit will be calculated in accordance with the principle explained above to determine the share of each partner in the profit of the business. In order to facilitate, ensure and encourage continuous investment in industry and commerce under the ' two tier ' system, it will be much better if the profit in such cases is determined with reference to the annual or bi-annual profits of the business in general.

All dubious and unfair practices, which could lead to misunderstanding, fraud, or damage to the interest and reputation of the business or either of the partners, should always be avoided. Moreover, any calculation of the profit and total value of the invested capital at any particular time, will require the joint agreement of the partners, since this will be essential for the success and reputation of the business.

Profit may be paid annually or bi-annually to the partners on mutually agreed

terms, and, if desired by them, the contract may be terminated after the division of the profit, or extended for a longer period, if it was for unspecified period. However, the period of contract is a matter for the bank and its partner or partners, who will take into account many factors to determine its duration: Such as the nature of the business, conditions of the market, availability and extent of capital etc.

(b) Bank-Depositor

This is the first-tier partnership in the two-tier system of *Mudarabah* banking. The bank receives ***Mudarabah*** deposits of various durations from its customers on the basis of profit sharing. It is in the best interest of both the bank and its customers that this capital is invested in some profitable enterprise at the earliest opportunity. It is also necessary that these investments are spread out to ensure a regular flow of profits for the bank. This policy of diversification will ensure that the bank will always get some profits; losses from some investments will be made good by profits from others while some may have yielded neither profits nor losses. The banks will share these profits with their ***Mudarabah*** depositors on an agreed percentage.

The total profits, as explained earlier, will be divided by the total *Mudarabah* capital in order to determine the actual rate of profit in percentage. Then every ***Mudarabah*** depositor will be paid his share of the profit according to his total share capital and the balance will be distributed among the shareholders in proportion to their respective share capital. If 20 shareholders establish a bank and each puts up £10,000 and a further 8,000 *Mudarabah* depositors each contributes £100, the total investment capital of the bank will therefore be £1,000,000 of which £200,000 is share capital and £800,000 is ***Mudarabah*** capital. This capital is invested on the basis of profit sharing – ***Mudarabah*** depositors receiving three-fifth (i.e., 60 percent) and the bank two-fifth (i.e., 40 percent) of the total profits of the business.

The bank invests this capital in partnership with some businessmen or firms on the condition that any profit will be shared between them on mutually agreed terms . At the end of the year, the bank finds that some of its business partners have made profits, some have incurred losses and some of them have made neither profits nor losses. The range of profits and losses made by different

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The bank invests this capital in partnership with some businessmen or firms on the condition that any profit will be shared between them on mutually agreed terms . At the end of the year, the bank finds that some of its business partners have made profits, some have incurred losses and some of them have made neither profits nor losses. The range of profits and losses made by different

partners also varies considerably. Thus, the bank can find itself in three situations. Firstly, after adding the profits and subtacting the losses of its various business partners, it may make a profit; secondly, after such additions and deductions, it may make a loss; and thridly, it may make neither.

If it has made profits, say £100,000 on its investment capital of £1,000,000, it has achieved a 10 per cent of profit on its total investments. Now these profits will be distributed among *Mudarabah* depositors according to the agreed terms of the contract, i.e., three-fifth (or 60 percent) share of the profits. On the basis of this percentage, their share of the total profits will come to £48,000 and the remaining £52,000 will go to the shareholders. Each shareholder will receive a profit of £2 ,600 on share capital of £10,000, giving him an average rate of profit of 26 percent. Every *Mudarabah* depositor on the other hand, will receive £6 in profit on his £100 capital (i.e.,6% profit), Thus, the average rate of profit of a shareholder will be much greater than that of a *Mudarabah* depositor.

In the case of a loss of £100,000, each *Mudarabah* depositor as well as shareholder will suffer a loss at the rate of 10 percent. Either they will pay this loss to the bank or their capital will be reduced by 10 percent. Thus, each *Mudarabah* depositor will be left with £96 instead of £100 in his deposit and each shareholder will have only £9,000 instead of £10,000 left in his share capital. And in the case of bank making neither profit nor loss, the *Mudarbah* depositors as well as the shareholders will neither receive nor pay.

On the whole, the shareholder receives a higher rate of profit than that of a *Mudarabah* depositor, but in the case of loss, both bear the burden at the same rate. This is because in the case of profit, the shareholder not only receives the full profit on his own share capital but also gets a share of the profits of the *Mudarabah* depositor thereby depriving the latter of the full profit on his own capital. This is due to the fact that the shareholder does all the banking business, spends his time, ability, skill and experience in making that profit possible from the business and has, of course, to pay his employees. His share in the profits includes wages for his hard work, reward for his managerial and enterpeneurial skill and return on his own capital.

Mudarabah depositor on the other hand supplies only a part of his capital e he is engaged in his own business affairs without taking in any capacity, r in either in the management or investment functions of the *Mudarabah* k. Above all, the shareholders assume complete responsibility for the ness and all the risks attached to it. Their liability is unlimited and in the e of loss they may not only lose their own entire capital but in certain cases y may also have to pay more than their share capital from their other rces to cover the heavy losses. In addition they are deprived of any reward all their work and hard labour. It is, therefore, equitable that the reholder is paid at a higher rate than a *Mudarabah* depositor in case of fits. And that a part of the latter's share is paid to him to compensate him his work and labour without which these profits would not have terialised in the first place.

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depositors and, as a result, the supply of *Mudarabah* deposits will rise and make available a greater volume of investment capital. It is, therefore, in the best interest of the business partner – both in the short-term and long-term to offer good profit-sharing terms to the bank (and thereby enabling the latter to offer similar profit-sharing terms to its *Mudarabah* depositors).

A business firm which shows poor results and offers lower percentage returns on bank loans will not have much chances of obtaining new loans. Banks will try to look for better alternatives for their investments because they themselves cannot attract any great volume of *Mudarabah* deposits at lower profit rate. A poor show of profits will deprive the business firm of its supply of loans from the bank and the latter will be deprived of fresh supplies of *Mudarabah* deposits. This then shows the singular importance of the rate of profits both in the bank-business and the bank-depositor relationship. The total volume of investment depends on the terms of these two rates of profits.

(c) Loan Deposits

Any loan capital raised by the bank from various sources (e.g., from the Deposits Account) and invested along with *Mudarabah* or *Shirkat* capital on the basis of profit making is the bank's own responsibility and any profit realised from it being wholly to the bank. It is only the loan obtained for a certain fixed period that has to be repaid under all circumstances. The bank has nothing to pay to its creditor in the form of profits but has only to return capital after the expiry of the loan period irrespective of the financial position of the bank.

For example, if £200,000 of £1,000,000 capital in the example mentioned under the Bank Depositor partnership is raised by loans, £200,000 by shareholders and £600,000 by *Mudarabah* depositors and is invested in business along with other capital profits will be divided along these lines: If the bank makes a profit of £100,000 on its total investment of £1,000,000 this will give it a 10 per cent rate of profit. According to the previously agreed terms, *Mudarabah* depositors will get a profit of £36,000 on their £600,000 *Mudarabah* capital at the rate of 3/5 (or 60 per cent), and the remaining £64,000 of the profits will go to the shareholders; (£32,000 on their *Mudarabah* capital and £32,000 on their loan capital) because it is their

responsibility to repay it whether profit or loss in business. In the case of a loss £100,000 shareholders will bear a £20,000 loss on their share capital and £20,000 loss on loan capital, thus bearing a total loss of £40,000 i.e. 20 per cent. *Mudarabah* depositors will bear a loss of £60,000 in proportion to their *Mudarabah* capital i.e. 10 per cent.) . In case of profits, shareholders make greater profits partly because of a share of *Mudarabah* profits and partly because of profit on loan capital and because in the case of any loss, they bear greater burdens owing to the loss on loan capital as well as *Mudarabah* capital. The greater the amount of loan capital, the higher the gain in case of profits and higher the burden of loss in case of losses.

As explained above under Bank Reserves, in order to make the system more sound and reliable, banks should maintain a bigger Reserve Fund from the profits. Whenever there is loss in business, the bank can pay off the losses from the Reserve Fund instead of demanding it from *Mudarabah* depositors and shareholders.

The maintenance of the Reserve Fund will practically eliminate the danger of loss in this form of partnership, both for the *Mudarabah* depositor and the shareholders. Although technically, both partners share in profits as well as losses they will share only in profits; losses will rarely fall on them because, if there are losses in any year, these will be paid off from the Reserve Fund. It is therefore deisrable and in the best interests of both the *Mudarabah* depositors as well as shareholders, that *Mudarabah* Reserve Fund be kept separate from the 'Banking Reserve Fund'. This will inspire greater confidence in the money market and keep the flow of *Mudarabah* deposits and thereby, the supply of investment capital both steady and stable.

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11

CENTRAL BANKING

A Central Bank is usually a non-profit institution, its main purpose being to regulate the flow of money and credit in the economy. It always acts as an instrument of the government in controlling the circulation of money and credit in the country. The central banks all over the world perform almost the same functions though they may differ in their forms of organisation.

Hawtrey regarded the essential characteristic of a central bank as the lender of last resort and pointed out that, while the right to issue notes gave a bank a great advantage in facing its responsibilities of the lender of last resort, it could nervertheless, perform that function without the right of issue.(1)

Shaw was of the opinion that "the one true, but at the same time all-sufficing function of a central bank is the control of credit."(2) In the opinion of Kisan and Elkin, "the essential function of a central bank is the maintenance of the stability of the monetary standard" which "involves the control of the monetary circulation,(3) while the statutes of the bank for International Settlement define a central bank as "the bank in any country to which has been entrusted the duty of regulating the value of currency credit in that country."

The main functions of a central bank are:

1. Banker of the Government

1. Hawtrey, R.G., *Art of Central Banking,* Cass, 1932,p.131
2. Shaw, W.A. , *Theory and Principles of Central Banking,* Pittman, PP.78–80
3. *Central Banking,* Macmillan, 1930, p.74

Government needs to hold its funds in an account in a bank into which it can deposit its money and on which it can issue cheques. It deposits its funds with the central bank. The Government, like an individual, needs to borrow money, and it usually raises its funds by selling bonds to the central bank, which increases Government deposits accordingly.

Bait-al-Mal was, in fact, the central bank of the Islamic State and performed this function on a much smaller scale. Since then, the economic system has grown much more complex and with it central bank has attained greater power and control on the money market of the country. Thus, *Bait-al-Mal* can be called the first central bank, as far as this function is concerned, in the history of banking.

2. Government's Agents and Advisor

A central bank is required to perform many kinds of services as an agent of the Government. The treasuries of many Western countries pass some of their financial duties, including the management of the national debt, to the central bank. It also keeps transfer registers in respect of Government stocks, conversion or redemption of state loans and the issue and redemption of treasury bills, etc.

A central bank also performs special agency services for the Government. It makes payments and agreements with respect to international trade and keeps separate banking accounts for such purposes. It acts as the Government's agent when exchange control is enforced.

3. Banker to the Commercial Banks

The commercial banks deposit some of their money in the central bank and borrow money from it. The central bank accepts deposits from them and transfers their funds to other banks. Thus, it provides commercial banks with the facilities of a chequing account and also acts as a means of settling debts with other banks just as an ordinary bank performs these function for its clients.

Lender of Last Resort

The commercial banks also, whenever they need, borrow liquid funds from the central bank. The central bank is called the 'lender of last resort' because it lends liquid funds to any commercial bank which is in financial trouble. Lending power is a very strong weapon of the central bank to regulate the flow of money and credit activities of the commercial banks.

The central bank's function of rediscount and lender of last resort has been developed from its power of monopoly of note issue. Originally the term 'rediscount' meant to cash trade bills for it was required to call all trade bills bought by the commercial banks and financial institutions to meet their temporary cash requirements. The bills of exchange served as a secondary cash reserve for the central bank. "The real object of rediscount by the central bank was that no sound and genuine business transactions should be restricted or abandoned merely on account of a shortage of bank cash, and it was originally considered that, as such transactions would or could ordinarily be represented by bills of exchange, it would be sufficient and appropriate if rediscounting were confined to genuine bills." But later on, due "to the enormous expansion of the credit structure caused by war debts, to the changes in the method of financing trade and in the structure of the money market, the bills were used less frequently in trade. There was a greater tendency towards commercial credit on open account and bank advances on current account." (4)

With increased national debts and Government expenditure, treasury bills were increasingly used by the commercial banks as a secondary reserve. "As a result of these developments, the central banks advance loans to the commercial banks and other credit institutions against bills of exchange, treasury bills, Government securities etc. And the term 'rediscount' began to be used in wider sense." (5)

5. Custodian of Cash Reserve

A central bank is the custodian of the commercial banks' cash reserves. The

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4. Debock, M.H., *Central Banking,* London 1973 pp. 88-89.

commercial banks are required to keep a certain minimum of the cash reserves of their time and demand deposits after lending or investing the remainder. They must also keep a certain minimum percentage of these deposits with the central bank. Different countries have set different standards for maintaining these cash reserve. In the U.S.A., for example the average Reserve Requirement is 15%, and in United Kingdom 8%.

The centralisation of cash reserves in the central bank helps to strengthen the banking system of a country. It can enable the central bank to utilise the centralised cash reserves in the best interest of the national economy. It can employ them in the most effective manner and to the fullest extent possible to safeguard the interests of the public, especially in times of financial crises and emergencies.

6. Controller and Regulator of Money Supply

This is the most important function of a central bank and it performs it in a number of ways:

(a) By controlling the issue of currency

The volume of currency in circulation in most countries is entirely determined by the central bank. The bank has unlimited power to issue money which is increased or reduced to meet the demand of the economy.

(b) By Regulating the activities of Commercial Banks through Reserve Ratio

The central bank makes it compulsory for every commercial bank to hold cash reserves well in excess or well below normal demand, according to the need of the economy. A rise in Reserve requirement can force the commercial banks to reduce their credit and vice versa.

(c) Open Market Operations

It is an important weapon in the hands of a central bank to influence the supply of money in the market. The central bank can purchase or sell Government securities or bills of exchange in the open market. If it wants to increase the supply of money in circulation, it starts buying bonds in the open

market and vice versa. These methods are known as 'Open Market Operations'.

(d) Other Weapons of Credit Control

A central bank can influence the supply of money and credit through other devices that operate through interest rates, discount rates and selective credit controls. Though these measures are much less important than the open market operations or Reserve Funds, they are often used by the central banks from time to time. One such method is the bank rate. Any change in the bank rate can exercise an immediate influence on all interest rates charged on short-term loans by the commercial banks of a country. This can influence the flow of foreign funds in either direction. A rise in the bank rate will attract funds into the country while a fall in it will encourage an outflow of funds from the home market.

Though open-market operations are meant to influence the volume of money in circulation, they also influence the interest rates. The purchase of large quantities of securities is likely to raise their price, which is equivalent to lowering the rate of interest; while sale of large quantities of securities is likely to lower their price and raise the rate of interest. Thus, an open-market policy designed to increase the supply of money in circulation also tends to reduce interest rates, and a policy designed to reduce the supply of money in circulation tends to increase interest rates.

The central bank can further adopt a variety of selective credit controls not only to control the supply of money or credit, but to encourage or discourage any particular form of it. It can regulate stock-market fluctuations in several ways, by controlling consumer credit, setting minimum initial payments and maximum terms for hire-purchase contracts ect. It can control credit supply by rationing its credit or imposing ceilings on total bank credit; by regulating marginal requirements with respect to purchases of stock exchange securities; by imposing advance deposits to be made by the importers etc. (5)

Finally, it can issue direct orders or suggestions to commercial banks and other financial institution operating in the country to adopt certain measures to achieve the desired results. With the co-operation of the commercial banking system, it can operate a tight money policy merely by asking banks to reduce

the volume of their loans; on the other, an expansion in money supply can be achieved by asking them to increase the volume of their loans.

In all these ways, a central bank tries to regulate the money or credit supply in a country.

7. International Financial Transaction

All financial payments and receipts relating to foreign trade and other financial matters are made through the central bank. All financial business with foreign countries is also conducted through it.

Islamic Central Bank

In the interest -free economy the Islamic Central Bank will perform almost all the functions of an ordinary central bank in the modern industrial economy. However, in the performance of its duties as an Islamic Institution, it will study and scrutinise the various functions and devices of the central banks, and will then adopt those that are compatible with the basic principles of Islam while rejecting all others which are contrary to them. It will thus be able to function in a way which is conductive to healthy banking and beneficial to society within the law of Shariah. In general, it will guide and supervise the activities of the commercial banks in order to ensure economic growth and stability in the economy. The main functions of the Islamic Central Bank will be as follows:

1. Government's Banker

It will be the banker of the Government and meet its various commitments as did Bait-al-Mal in the earlier times. The Government can keep all its funds in it, or may, if it so desires, like the Government of the United States, keep some of its funds in the commercial banks. In our opinion, it would be in the best interests of the community if all the funds of the Government are kept in the central bank.

2. Banker's Bank

It will be a banker for all other commercial banks in the country. All commercial banks will be required to maintain their accounts with it and, will

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2. Banker's Bank

It will be a banker for all other commercial banks in the country. All commercial banks will be required to maintain their accounts with it and, will

be able to obtain loans from it whenever they need them.

3. Foreign Payments and Foreign Trade

It will supervise all financial matters dealing with foreign countries and all such payments will be made through it. All foreign trade will be controlled by it and all exports and imports will be conducted under its supervision, so that it can maintain its relationship with international banking institutions and, at the same time, protect the national financial system from the curse of interest and other such practices.

4. Currency Control

It will issue and manage currency on behalf of the Muslim State.

5. Advice and Guidance to Commercial Banks

It will give advice and provide guidance to the commercial banks on important policy matters and will also issue directives to all the commercial banks on all matters concerning the common good of the state. It will usually consult the commercial banks in all such matters, but, if necessary, such instructions can be issued in the form of rules and regulations for the guidance of the commercial banks.

Reserve Ratios

Under modern banking practice, all central banks require the commercial banks of their respective countries to keep a certain part of their capital in cash in order to maintain their liquidity at a reasonable level to meet the cash demands of their customers. This is called Reserve Ratio. They must maintain a part of this reserve ratio with the Central Bank and, in return they are allowed borrowing facilities from it in times of crisis or need.

The Islamic Central Bank will require the commercial banks to maintain two Reserve Ratio; (a) banking reserve and (b) demand reserve. The former is to meet the general cash requirements of its clients and the latter to meet the demand for short-term interest-free loans.

Banking Reserve

The Islamic Central Bank will, like any other central bank, require the commercial banks to keep a certain percentage of their total deposits (including demand and savings deposits) in cash at all times to meet the daily cash requirements of their clients and this is known as the Banking Reserve.

A part of the Banking Reserve is to be deposited with the Islamic Central Bank. The percentage of the Reserve Ratio varies with the variation in the nature of demand for cash in different countries; in the United Kingdom, 8 per cent of total deposits must be covered by cash reserves, whereas in the United States, the average reserve requirement is about 15 per cent. (5)

Though people normally like to keep a certain amount of money in cash with them all the time, their demand varies from time to time and place to place. Sometimes they want to keep more cash and at other times they need less; times of annual festival holidays or at the beginning of the week or month, when they want to do weekly or monthly shopping, there is a greater demand for cash. Political and economic conditions also affect people's cash requirements. It is, therefore, desirable that at such times the commercial banks should have sufficient liquid funds at their disposal to meet the requirements of their clients. Normally, banks do keep a sufficient portion of their deposits in more or less liquid form for such emergencies, but if they find themselves in difficulties they have a right to ask the Islamic Central Bank for a supply of cash as a result of their deposits with it. As explained before, it is obligatory upon them to keep a certain part of their assets (i.e. reserves) with the Islamic Central Bank, and the latter, in return, undertakes to supply cash to them whenever such need arises.

The Islamic Central Bank can use this Reserve Ratio, like the modern Central Banks, to increase the supply of money in the market. This is because a rise in the Reserve Ratio will cause the commercial banks to contract their deposit money, thereby reducing their lending power; while a fall in the Reserve Ratio will encourage an expansion of deposit money, resulting in an expansion of loans.

This can be seen in its simplest form by comparing Table VI, Column A below, which shows the supply of loans when the Reserve Ratio is 10 percent, with column B, which shows the supply of loans at 15 percent Reserve Ratio:

Table VI

(With No Cash Drain)

ASSETS			LIABILITIES		COL.
Reserve Ratio	Mudarabah Loans	Short-term Interest-Free Loans	Mudarabah Deposits	Demand & Savings Deposits	
10 percent (£1,000)	£6,000	£3,000	£5,000	£5,000	A
15 percent (1,500)	£5,667	£2,833	£5,000	£5,000	B

Column A, shows that when the Reserve Ratio is 10 percent total liabilities in the form of ***Mudarabah*** deposits and demand and savings deposits are £10,000 (£5,000 in each deposit). The total assets advanced as ***Mudarabah*** loans and short-term interest-free loans are £6,000 and £3,000 respectively; and the total Reserves are at £1,000. Column B shows the position when the Reserve Ratio is raised to 15 percent, liabilities in ***Mudarabah*** deposits and demand and savings, deposits being the same i.e. £5,000 in each deposit; while the total assets advanced as ***Mudarabah*** and short-term loans fall to £8,500, (£5,667 and £2,833 respectively), and the Reserve stand at £1,500.

This shows that whenever the Islamic Central Bank orders an increase in the Reserve Ratio to be maintained by the commercial banks against their total deposits, the latter try to withdraw loanable funds from their advances in order to increase their cash reserves. This gradually leads to a reduction in the volume of credit money both in ***Mudarabah*** and short-term loans so that the ratio

tween the two becomes the same. In this case, when the Reserve Ratio was percent, investments in ***Mudarabah*** loans and short-term loans was 2:1; as Reserve Ratio was raised to 15 percent, there was a gradual withdrawal of nds from both until they stood at £5,667 and £2,833 respectively i.e. a ratio f 2:1;

is slow process because funds from ***Mudarabah*** cannot be withdrawn at short otice. Besides, it is never prudent to withdraw funds from productive vestments and it may sometimes prove disastrous. The banks in this case would therefore, prefer not to touch ***Mudarabah*** loans for the time being and would try instead to raise funds partly by withdrawing some short-term loans and partly be selling their industrial shares or government securities (if they have any) to meet the new cash requirements and wait for the appropriate time to make necessary adjustments in respect to ***Mudarabah*** loans. In one way or another the banks have to raise their cash reserves in order to meet the 15 percent Reserve ratio, no matter how and by what measures they achieve it.

Another point worth mentioning in this respect is that the banks would not be able to withdraw more funds than is absolutely necessary from short-term loans for they have also to maintain it at a certain required ratio to the total amount in demand deposits, in this case about 60 percent.

If on the other hand the Islamic Central Bank wants to increase the amount of money supply in the market, it will lower the Reserve Ratio, say to 5 percent, which will gradually lead to an expansion of loans. This can be seen in its simplest form in Table VII. Column B shows the supply of loans when the Reserve Ratio is reduced to 5 percent of the total deposits.

It also shows total liabilities of £10,000 (£5,000 *Mudarabah* deposits and £5,000 Demand and Savings Deposits) at a Reserve Ratio of 10 percent and total loanable assets of £9,000 (£6,000 *Mudarabah* and £3,000 short-term loans) with £1,000 cash reserves. When the Islamic Central Bank lowers the Reserve Ratio to 5 percent, liabilities remain the same at £10,000 (£5,000 *Mudarabah* and £5,000 Demand and Savings Deposits); while the total volume of loanable assets rises to £9,500 (£6,333 *Mudarabah* and £3,167 short-term loans) with £500 cash reserves.

Table VII
(With no Cash Drain)

ASSETS			LIABILITIES		COL
Reserve Ratio	Mudarabah Loans	Short-term Loans	Mudarabah Deposits	Demand & Savings Deposits	
10 percent £1,000	£6,000	£3,000	£5,000	£5,000	A
5 percent £500	£6,333	£3,167	£5,000	£5,000	B

Inspite of all these changes in ***Mudarabah*** loans, and short-term loans, the ratio between the two quantities remains unaltered at 2:1. As a result of reductions in the Reserve Ratio, the banks are left with an extra £500 with them to lend to their ***Mudarabah*** enterprises and short-term borrowers. Thus businessmen will receive an extra £500 which will again be deposited with the banks, thereby increasing their supply of loanable funds. If investment opportunities are availabe in the market, businessmen will invest and re-invest this extra £500 in productive enterprises while all the time increased funds will be coming to the banks in their various deposits, thereby increasing their supply of loanable funds.

This then is the sequence by which a fall in the Reserve Ratio has created an expansionery tendency, both in the field of deposits and business investment: release of cash reserve — greater investment in business — more creation of real wealth — increased deposits — more loanable funds — and greater investment etc.

When the banks have an extra £500 in cash deposited with them at a 5 percent fall in the Reserve Ratio, they can buy industrial shares instead of investing in ***Mudarabah*** business, but the overall effect of this action will also be the same, i.e. expansion of business and deposits etc.

Thus, the Islamic Central Bank can quite successfully and effectively use the Reserve Ratio weapon to increase or decrease the supply of loanable funds in the market, and also control or regulate the total volume of money in circulation.

Bank Rate Policy

Bank rate policy is a common weapon in the hands of modern Central Banks to control the flow of funds in the country, but in an interest-free economy, the Islamic Central Bank will be deprived of this instrument of control. However, it can use Reserve Ratio as an effective alternative weapon to achieve the same results.

Lending Ratio

The lending ratio is the ratio of commercial banks loans to their total demand (or current) deposits and is imposed on the banks by the Islamic Central Bank as a condition for advancing loans to them in case of need. It determines the proportion of their demand deposits which the banks are required to keep in cash as well as the proportion which they are free to invest in profitable enterprises on the basis of ***'Mudarabah'***. This is also called the 'lending ratio', and it can become a strong weapon in the hands of the Islamic Central Bank as a means of adjusting the supply of interest-free loans with their demand.

The Islamic Central Bank can increase the supply of interest-free loanable funds merely by increasing the lending Ratio and reduce the supply of these funds by lowering the lending ratio. For example, if the lending ratio is 40 percent and the Islamic Central Bank intends to increase the supply of loanable funds, it may increase it to 45 or 50 percent according to the loan requirements of industrialists at any particular time. If it finds that the supply of loanable funds in the market is more than the existing demand for it, it may reduce the lending ratio to 30 or 25 percent according to the trend of demand.

Lending ratio can also be called a "refinance ratio" for it will determine the total quantity of loan money given by the Islamic Central Bank to the commercial banks, depending of course, on the proportion of demand deposits

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Lending ratio can also be called a "refinance ratio" for it will determine the total quantity of loan money given by the Islamic Central Bank to the commercial banks, depending of course, on the proportion of demand deposits

made available by them to the industrialists as interest-free loans. As pointed out before, this can become an effictive instrument in the hands of the Islamic Central Bank, not only to control the volume of credit, but also to ensure bank's liquidity.

It may, however, be pointed out, that under this 'refinance scheme', all loans given by the Islamic Central Bank will be of short duration. The commercial banks will finance the short-term needs of industry from their demand deposit Reserve Fund which they are supposed to maintain for this very purpose under the 'Lending Ratio' requirements of the Islamic Central Bank. Whenever the banks need additional funds to maintain their liquidity in order to meet the short-term cash requirements of industry, they can easily get them from the Islamic Central Bank. It is healthy and good omen for the success of interest-free banking that easy loans (without interest) will be available to the banks in sufficient quantities on demand from the Islamic Central Bank. In modern banking, the central bank is always willing to advance loans to the commercial banks, but charges interest on all such loans. And it can increase the rate of interst whenever it feels it is desirable or necessary to reduce the supply of loanable funds in the market and vice versa. It is a strong instrument of the modern Central Bank by which it can regulate the volume of money in circulation.

As in the interest-free economy, the Central Bank will be working in close co-operation and under the direction of an Islamic State, it will always be able to use these policy instruments to control and regulate the volume of money in circulation in the best interests and the general good of the community. If it finds that industry is in a fundamentally very healthy state, but because of a shortage or lack of funds cannot expand, it may take the necessary steps to ease the sitution by raising Lending Ratio or Refinance Ratio and vice versa. What steps it may take to expand or contract the supply of credit will depend on the community at any particular time. The actual operation of this instrument in the interest of a free economy will show the effectiveness or otherwise of this policy.

Lending Ratio can also used by the Islamic Central Bank as a means of selective credit control by fixing different lending ratio for different industries or for different kinds of loans. Thus, by fixing a high ratio for certain industries, it

can encourage banks to grant more loans to that industry and vice versa. (5) Naturally, commercial banks will try to provide more loans to such industries in order to get more funds from the Islamic Central Bank. Through selective credit control, the Islamic Central Bank can use Lending Ratio as an effective instrument for expanding or contracing the supply of credit in different sectors of the economy.

Terms of Allocation

The Islamic Central Bank shall have to lay down definite and clear-cut rules in order to protect the community from possible fraud by commercial banks or their borrowers. It will have to scrutinise every application and supervise the whole process of granting loans to ensure that the total quantity of loans is in proportion to the cash requirements of the public and that the new funds are not made an instrument of further advances to businessmen.

It must also be made clear that these interest free loans are only for short duration and must, under all circumstances, be repaid during that period and not renewed in one form or another. All precautions must be taken to discourage the practice of delaying payments. No further loans must be made to defaulters, or if it is thought desirable and necessary, fines can be imposed on such people.

In case of default, owing to the solvency of any debtor, the Islamic Central Bank should accept the responsibility to pay off such unpaid debts to the commercial banks. This is quite right because these loans were provided free of interest on the initiative and pressure of the Islamic Central Bank in the first place,. The loans may be paid by the Treasury direct from the taxes or from the ***Zakat*** Fund to the Islamic Central Bank. The latter method seems right within the scope of ***Zakat*** beneficiaries as explained under *Zakat* in vlume 111 of this book.

The Islamic Central Bank may also lay down rules and regulations governing

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5. Dr. M.N.Siddiqi – Paper read at the International Economic Conference, London – April 1977.

the terms and conditions of the allocation of loans by the commercial banks to respective applicants. These conditions will be more or less the same as are required by the modern banks for similar loans. Among other things, ***Mudarabah or Shirkat*** (share) capital of individuals or firms can be accepted in security against these loans. Sometimes the creditability and trustworthiness of certain individuals may be accepted as personal security against these loans as with modern banks. Normally, commercial banks will give loans against personal security only to their regular clients in ***Mudarabah or Shirkat*** partnership in whom they have full confidence.

In granting these loans, the Islamic Central Bank will take into account the optimum use of the loan capital by the commercial banks and its likely benefit to the community. The need for such action may become necessary in case of a constant excess of demand over the supply of loanable funds. In these circumstances, the Islamic Bank will have to scrutinise fully the need of each applicant for such a loan and his ability to repay it. It may also look into the nature and quality of any security given by the applicant against the loan. Thus, applicant with more urgent need, greater financial ability to repay the loan at the proper time and with more reliable guarantees, will stand a better chance in acquiring loans. The Islamic Central Bank may also allow the commercial banks to give perference to their clients in ***Mudarabah or Shirkat*** 'partnership' in the allocation of interest-free loans.

The Islamic Central Bank will also check and scrutinise the fees charged by the commercial banks from the applicants for interest-free short-term loans to ensure that they do not make it a means of income. Such fees are meant to cover only service charges incurred during the receipt of application of funds. As the commercial banks are making these loans out of the demand deposits Reserves for which they pay nothing and because they also use a part of these deposits for profitmaking, they may indeed decide not to charge applicants any fees at all.

Benefits:

Interest-free loans may prove very useful for the economy in several ways. The great majority of people receiving these loans will be industrialists and businessmen already engaged in productive work. With financial assistance

from the commercial banks, they will be able to meet some of their occasional needs without any cost. Something which will greatly help in establishing their business on stable and solid footing; in the absence of these loans, they might well have suffered great hardship or loss to their business interests.

Farmers, after the harvest and before the sale of their crops, and manufacturers, during the period between the finished products and their sale, both need short-term credit without which they may incur heavy losses. But with this short-term credit, these people are enabled to make their industries viable and prosperous. As their profits increase, their deposits with the commercial banks increase, thereby increasing the loanable funds and hence the profits of the banks. Thus, as these people prosper, they enrich the banks as well as the community.

It is not in any case a very profitable course for the banks to keep a large quantity of resources in cash money to meet the verying needs of the depositors when most of the time, the great majority of them do not claim their deposits. The commercial banks normally keep a certain proportion of their deposits in cash to meet such demands, and they rise especially when the market is not steady and people have lost confidence in the banks, or when there is high rate of inflation and people want to spend their cash money in buying durable goods or put it in other such investments. All commercial banks, in these circumstances, will be under great preassure from the public for cash. They shall have to divert some of their funds from productive enterprises to meet this demand, something that will be very unprofitable for them. But in the interest free economy, commercial banks need not keep such large cash reserves or transfer their funds from productive sources because they can always go to the Islamic Central Bank and demand cash needs on the basis of 'Lending Ratio'.

Thus, a great benefit of this ratio for the commercial banks of the country will be in the form of saving because they will not be keeping huge funds in liquid form for meeting cash demands from their depositors. They can keep their funds employed all the time in productive channels and whenever there is a demand for cash, they can go to the Islamic Central Bank for help.

Purchase and Sale of Industrial Shares

Government industrial shares will replace bonds and securities and will provide the Islamic Central Bank with an instrument for 'open Market Operation'. In the modern monetary system, the central banks can regulate the supply of money through the purchase or sale of short-term securities, but this will have no place in an interst-free economy. However, the same objective can very successfully be achieved through the purchase or sale of Government industrial shares by the Islamic Central Bank. If it wants to increase the supply of money in circulation, it can offer better terms to the holders of industrial shares and thus tempt them to sell their shares,. This will release more money on the market, thereby increasing the total supply in circulation. On the other hand, if it wants to reduce the supply of money in the market, it can start selling industrial shares at reduced prices on the open market.

It can also protect the share market from the speculative ventures of some misguided financiers by its open market operations. It will keep itself fully informed of the share prices and profitability of its *Mudarabah or Shirkat* industries, and whenever there is any unusual fall in prices below the normal market rates it will start buying the shares at the market rate which will check the fall and, instead, raise their prices. On the other hand, if it finds share prices rising above the market rate, it will start selling its shares until prices come down to the market rate. Thus, by buying and selling these shares at the appropriate time, the Islamic Central Bank can keep their prices stable and protect the market from abnormal changes. This will also deprive the speculators from manipulating the market and making artificial changes in share prices as a safe means of profit making.

The market price of shares will normally depend upon their annual earnings. If some industrial shares have yielded more profits in any year than others, their price is likely to rise because of greater demand for them. If there is tendency for the shares of a particular industry to maintain high profit for a number of years, the market price of its shares will be maintained at a higher level than other shares with low average annual profits. In any year the market value of shares in general will depend partly on their average yield in the previous year, especially the current year and partly on estimates of profits for the coming year. Market share prices will more or less vary according to these estimates. And it is the duty of the Islamic Central Bank to see that the share prices vary

around the average market rates of profits and do not suddenly rise or fall on account of baseless fears or any false expectations of the speculators.

If there is any abnormal change in the market prices of shares, the Islamic Central Bank will intervene through its usual manner of buying or selling these shares as the case may be until the prices have reached the normal market rate. In general, however, it will leave the shares to move about around the average market rate.

The Islamic Central Bank can also expand or contract the quantity of money by buying or selling these shares from the commercial banks. Whenever the commercial banks need more money or it is desirable or necessary in the interest of the general good of the economy that they should have more funds, the Islamic Central Bank may start buying these shares from them on more favourable terms. And in this way release more funds for their use and vise versa.

Thus, the Islamic Central Bank can achieve three-fold objective through the purchase or sale of Government industrial shares. Firstly, it can increase or decrease the total volume of money in circulation in general. Secondly, it can protect the share prices from sudden changes through the activities of speculators. And thirdly it can expand or contract the quantity of money supply with the commercial banks. The first two are not however its normal functions. These may have to be used by the Islamic Central Bank in great emergencies because the Reserve Ratio is the normal and common instrument of the Islamic Central Bank to increase or decrease money supply in the market.

For this purpose, it is essential that the Islamic Central Bank must have a sufficient quantity of Government industrial shares of all kinds, otherwise it will not be in a position to have much effect on the market. In addition, the co-operation of the commercial banks is also necessary because without it these measures cannot be effective and successful.

Purchase and Sale of Industrial Shares

Government industrial shares will replace bonds and securities and will provide the Islamic Central Bank with an instrument for 'open Market Operation'. In the modern monetary system, the central banks can regulate the supply of money through the purchase or sale of short-term securities, but this will have no place in an interst-free economy. However, the same objective can very successfully be achieved through the purchase or sale of Government industrial shares by the Islamic Central Bank. If it wants to increase the supply of money in circulation, it can offer better terms to the holders of industrial shares and thus tempt them to sell their shares,. This will release more money on the market, thereby increasing the total supply in circulation. On the other hand, if it wants to reduce the supply of money in the market, it can start selling industrial shares at reduced prices on the open market.

It can also protect the share market from the speculative ventures of some misguided financiers by its open market operations. It will keep itself fully informed of the share prices and profitability of its *Mudarabah or Shirkat* industries, and whenever there is any unusual fall in prices below the normal market rates it will start buying the shares at the market rate which will check the fall and, instead, raise their prices. On the other hand, if it finds share prices rising above the market rate, it will start selling its shares until prices come down to the market rate. Thus, by buying and selling these shares at the appropriate time, the Islamic Central Bank can keep their prices stable and protect the market from abnormal changes. This will also deprive the speculators from manipulating the market and making artificial changes in share prices as a safe means of profit making.

The market price of shares will normally depend upon their annual earnings. If some industrial shares have yielded more profits in any year than others, their price is likely to rise because of greater demand for them. If there is tendency for the shares of a particular industry to maintain high profit for a number of years, the market price of its shares will be maintained at a higher level than other shares with low average annual profits. In any year the market value of shares in general will depend partly on their average yield in the previous year, especially the current year and partly on estimates of profits for the coming year. Market share prices will more or less vary according to these estimates. And it is the duty of the Islamic Central Bank to see that the share prices vary

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12

Government Loans

As already explained, whenever the Government needs more money it has also to borrow (although it may choose the easy way of printing more notes). It occasionally raises funds by selling securities directly to the public or to the Central Bank, which buys them and gives the Government in return a deposit of the amount it requires. It is really a form of loan obtained by the Government from the Central Bank. The Government borrows money to meet its exess expenditure over its revenue just like an individual borrower, though the nature, method and purpose of its loans are quite different. It will also need long-term as well as short-term loans for its various requirements and most of these loans are raised through the Central Bank, the Government's banker.

It will need long-term loans for its development schemes and the establishment of its basic industries, e.g. transport and communication, irrigation, electricity projects, the arms and ammunition industry for defence. It will also require short-term loans for its multifarious educational and welfare needs, including the cost of running the civil service, the army, the police force, the health service and for making social security payments. Expenditure (i.e. capital costs) on the basic communal industries is normally paid for by the Government from the borrowed capital, and is repaid over the working life of the essets, while the cost of running the public services (i.e. currently consumed items) is paid for out of the revenues raised by taxes and other fiscal measures. The same policy of payments will more or less be followed by the Islamic State for paying debts.

The Islamic State will levy taxes to meet its normal expenditure on currently consumed items and occasionally, depending on the economic state of the economy, it may resort to deficit financing like the modern Western states. It can also receive loans from the Demand Deposit Reserves of the banks through Central Bank to meet its short–term expenditure. The real difference in e Islamic State and the modern Western States will be seen in its apporach to sing long-term loans . Modern states can very easily raise funds to meet their g-term commitments simply by offering higher rate of interest on their ious bond and securities, but the Islamic State will have to find other ways motivating the owner of capital to advance such loans, in the absence of erest. (1) When the public are getting nothing in return for their money w can they be induced to advance such interest free loans to the overnments? In the absence of interest some other inducement must be und to make them willing to give various kinds of loans to the Islamic State.

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In this way, the Islamic State will find it easier to convince people of the necessity of such schemes for the welfare of society in general and for the low-low-paid income groups in particular. It is hoped that by disseminating information about the usefulness of its projects and by moral persuasions, the Islamic State will be able to convince as many people as possible to give a part of their surplus wealth as loans to it for the pleasure of *Allah* instead of investing it for earning more wealth. The Government can raise a sufficient quantity of money in loans in this way, especially in times of war, if it has rightly and properly educated people about the significance and importance of its objectives. The people, we are sure, will contribute generously to finance

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1. For details of such motivation see Public Maintence in Volume 1 of this book.

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the development and other social welfare schemes of the Government through interest free loans for the pleasure of *Allah*. (رضوان اللہ) (2)

In addition, the Islamic State can also find some economic motives to raise adequate reserves for its various schemes. There are always people who want to save their money for the future, but are not prepared to risk it in profit-sharing projects. They know that in profit-sharing projects there is a possibility of huge profits, but also the possibility of loss cannot be completely ruled out. In view of both possibilities there is small element of risk which these people are not prepared to take under any circumstances. Their only object is to save their money for furure needs and get it back when needed without loss. Such people will be inclined to deposit their money for safe-deeping in Government loans instead of in bank's saving or Demand deposits accounts.

A Government loan is, for obvious reasons, more secure and reliable than a deposit with a bank. A Government is more dependable and its promise more reliable than that of an ordinary commercial bank because the lender has a guarantee of the Government for the repayment of the loan after a certain date. And many people in these circumstances, will definitely give preference to Government loans over banks deposits as their main purpose is safe keeping. Besides, it will be an act of goodness for they will be helping the Government in the interest of common good of society. Thus, the Islamic State will be able to collect large funds from this class of savers through different types of loans of varying amounts and duration.

To attract more funds from this and other categories of capital owners, the Islamic State can offer, along the same lines of modern states, more concession in the form of relief in income tax and wealth tax, so that people who give loans pay less income tax and property tax than they would otherwise pay. For this reason, people who deposit their money for long periods with banks for safe-keeping or who keep it in their own possession will have a strong incentive to loan it instead to the Government. This measure will certainly attract most of the capital, if not all, of the first category of savers, who merely want to save their money without risk of loss. This same concessionary measure will

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2. Dr. Mohammed Nejatullah Siddiqui. ***Intrest Free Banking*** (Urdu), Lahore 1969, pp.100–109.

also appeal to another class of people who would like to contribute to Government development and welfare schemes for the common good of society, and because they are not sufficiently financially well off to forego them, may tempt them to withdraw some of their investments from profit-sharing enterprises and transfer them to Government loans. This will enable them to satisfy their national pride of serving the common good of society at less financial sacrifice.

It may also attract another category of people who are neither rich nor poor, but who have strong feelings of national and religious service to their community. Ordinarily, such people provide their services free of charge to society but do not contribute much in monetary terms. This same measure may also provide them an added motive to contribute to Government loans by reducing their expenditure on non-essentials. There is thus every likelihood that the Islamic State will be able to increase the supply of its loans considerably in this way. It may however be pointed out that the amount of money in tax should under no circumstances be allowed to exceed the total amount of loan money received through this measure, otherwise it will become unproductive. Another point to remember is that the tax concession system should be devised in a way that is fair and just to all those who contribute to Government loans – small servers, big capitalists, or large property owners. It should not lead to unequal or unfair treatment to any of these classes.

More specific measure that the Islamic State may take to raise funds to meet its expenditure are discussed below:

1. Loan Certificates

In an advanced and progressive economy it is an almost constant need of a modern Government to raise funds through loans of various kinds since this seems to be the only practical way to finance its multifarious projects. The usual way a modern Government sets about is to issue securities of different values and of different durations. Short-term loans, for instance, are needed by the Government to cover short-term and day-to-day costs while its revenues are collected only in tax realisation periods. This need is met by modern Governments through the issue of short-term treasury bills, bearing interest.

The Islamic State can issue similar securities or bills in the form of loan certificates of different denomination and duration, but carrying no interest. These Loan Certificates may vary in value and can be of as low as £5 and as high as £50,000 or more, and can also be of varying duration, ranging from one month to 12 months and one year to between five and seven years. Each Loan Certificate will bear its value and the date of its maturity or repayment. These Certificates will be issued only by the Government, but through the agency of the Islamic Central Bank. Individuals or institutions will not be allowed to bargain in these certificates at a lower price before their maturity like bills of exchange. However, these certificates can be encashed at par on or after the date of their maturity at any post office or bank. This provision is necessary to avoid dealings in interest. And as these certificates cannot be exchanged at less than the actual value written on them, there will be no real motive for their exchange on or before the date of maturity.

The commercial banks will buy large quantities of loan certificates to strengthen their liquidity. They will wish to keep certificates of varying duration so that whenever they need money, they could get cash for them; and for this reason they will prefer to have loan certificates of shorter duration. These certificates may be offered as security against loans from the commercial banks or from individuals. The commercial banks normally demand high quality security against their short-term interest-free loans and these certificates will ideally serve that purpose. Besides, it will be for the banks to see that the date of maturity of these certificates is before or near that date of repayment of their own loans. (2)

2. *Shirkat(* (Partnership) Certificates

The Islamic State can find another source of income for meeting its capital costs by organising and securing profitable enterprises in partnership with the public. Profits from these enterprises can form a permanent source of income. Funds for these industries can be raised through the sale of shares among the people. In order to keep its control over these enterprises, the Islamic State may itself buy 51% of the share capital and offer the remaining 49% to the public. Having the ownership of a majority of the shares will enable the bank to have full and effective control over the management and running of these industries. This is an essential condition of ***Shirkat*** because it enables the enterprises to be run in the best interest of the community and not to be

exploited by a section of people.

Shirkat shares will be offered for sale to the public through the agency of the Islamic Central Bank. These shares will constitute titles of ownership of the business in proportion to their value and will be transferrable and marketable on the open market. Profits on these shares may be distributed bi-annually or annually, depending on the common custom of other enterprises in this respect. The value of these shares may vary from anything from £10 to £100,000 or more, if it is thought desirable in the common interest of the community. These shares may be of various duration, ranging from one year to ten years, and can be of longer duration, say twenty years, to attract capital from those business-minded people who want to invest their funds for long periods.

Shirkat shares may be of two kinds; limited and unlimited liability shares. The former will be of small denomination and short duration. People who want to share in profits without taking long-term risks or who have small savings and do not want to lose them, can be induced to buy shares with limited liability; while businessmen who want to make profits and are prepared to invest large funds as well as to take risks, will be willing to buy shares with unlimited liability. This will enable the Islamic State to collect investment funds both from short-term and long-term investors.

The terms and conditions of ***shirkat***, the percentage or proportion of profits on each share, the timing of the distribution of profits or losses and other relevant matters must be clearly stated on the share certificates without any doubt being left about any matter. Both kinds of shares must also state the nature and extent of the liability of each partner. For example, limited liability shares will state that the liability of the shareholder is limited to the value of his shares and likewise, unlimited liability shares, that the liability of the shareholder is unlimited.

Privately-owned ***Shirkat*** shares can be sold or bought in the market at their face value because every shareholder is at liberty to sell his shares he likes. Whenever these shares are sold, the company's registers must be informed of the transfer of ownership so that necessary changes in the name and address of

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the new owner are made in the registration books. Government-owned shares, on the other hand, are not subject to these conditions. these shares can be sold or bought at the market price, depending on the estimated or real profits of the public-owned industries which may be above or below the actual price of the shares. the owners of the Government *Shirkat* shares can sell them, or buy new ones, at any price they please. The market price of these shares is normally affected by the current profits and estimated profits for the coming year and the market price will rise or fall according to any expected rise or fall in the profits of the public-owned enterprises. (2)

Owing to the Government's huge credibility these shares will enjoy a wide market circulation. For various reasons individuals, financial institutions and banks will all buy large quantities of them. Individuals will buy them to make profit while the banks will buy to make profits as well as to keep a considerable part of their assets in a form that can readily be converted into cash and Government shares can be a good secondary reserve to them. Islamic Central Bank will also buy large quantity of Government *Shirkat* shares which will enable it to increase or decrease the supply of money by buying or selling these shares in the open market or with the commercial banks when the need arrives.

3. Government *Mudarabah* Shares

Government *Mudarabah* Shares can prove to be another important regular source of revenue for the Islamic State and part of profits from them can be used to meet its capital costs. The practical form of *Mudarabah* partnership by the Government can be like this. The Government can buy shares of a fixed value of any successful and prominent industry, firm or business enterprise and then offer them for sale on the open market, through the egency of the Islamic Central Bank. These shares can be of varying duration, ranging from one to five years and of varying denominations , ranging from five pounds to £50,000 or more.

The difference between Government *Shirkat* and Government *Mudarabah* shares is, firstly, that the former confer a title of ownership while the latter do not. Secondly, the former can be bought and sold like any personal possession in the open market, while the latter cannot be sold in this way. Thirdly, the former give the owner the right to share in the management and running of the

business enterprise, while the latter do not do so. Fourthly, the former give a greater proportion or percentage of profits to the shareholder than that of the latter. Like the *Shirkat* shares, the propotion or percentage of the profits of the Government and of the *Mudarabah* shares will be clearly stated on these shares along with the amount and date of maturity. Unlike *Shirkat* shares, these shares will not be titles to ownership, but will merely state the amount of capital supplied by the holder for investment purposes on the basis of profit-sharing in *Mudarabah* partnership. The holder will be entitled to the specified proportion or percentage of the profit. These shares cannot be sold or bought like *Shirkat* shares. They are thus non-transferable, but the holder can withdraw his capital along with profits (or loss) on the completion of the period stated on the share certificates from any post office or commercial bank.

There is every reason to expect that a competitive rate of profit can be guaranteed to the holders of these shares by the government. Modern state, which finance public industries and enterprises with borrowed funds on quite high interest rates, not only pay back large sums of money in interest, but also succeed in making good profits. We therefore, have every reason to be optimistic that the Islamic state will be able to offer its *Mudarabah* shareholders reasonable profits. These type of shares will be especially popular among those people who both want to save and make a little profit at the same time as long as the element of risk is comparatively low or negligible. *Mudarabah* shares offer them such an investment.

The Islamic Central Bank will also buy a considerable number of government *Mudarabah* shares not for profit-making, but for helping government-financed industries and enterprises to get more capital and also for increasing its own near-liquid assets. Many other financial institutions may also find these shares an appropriate form of investment for their capital.

The supply of capital in these forms of government shares depends on the expectation of profits from these industries. The greater the expectation of these profits, the larger the supply of capital will be through the purchase of these shares. It is therefore desirable that the Islamic state should inspire confidence in the holders of its shares and remove any element of uncertainty regarding profit. This can be done by maintaining a Reserve Fund from its

Profits along the lines of the commercial banks, which will ensure the payment of regular profits to its shareholders, irrespective of any profit or loss in any particular year, thereby guaranteeing regular supply of capital .

A regular monthly or any other suitable periodical issue of these three types of loans and shares will ensure a regular supply of sufficient supply for the government to meet its demands, including financing long-term development projects, welfare schemes and public or semi-public enterprises together with the repayment of mature loans (or shares).

Stock Exchange

The stock exchange will operate in an Islamic economy, but on different principles. Its nature and aim will be fundamentally different from that of the modern stock exchange. Government-owned shares and certificates and shares of private companies will be bought and sold in the open market but their market value (i.e. price) will be determined by the industries and not by the speculative activities of certain groups of people. All speculative dealings will be forbidden and the central bank will keep a close watch at the market prices of various shares and certificates to ensure that they do not vary too much from the actual or estimated profits of their respective companies. The presence of the stock exchange will enable the free buying and selling of shares on the open market but without any profiteering through speculative activities of selfish people.

وَكَمْ أَهْلَكْنَا مِنْ قَرْيَةٍ بَطِرَتْ مَعِيشَتَهَا ۖ فَتِلْكَ مَسَاكِنُهُمْ
لَمْ تُسْكَنْ مِنْ بَعْدِهِمْ إِلَّا قَلِيلًا ۖ وَكُنَّا نَحْنُ الْوَارِثِينَ

SECTION SIX

THE ISLAMIC DEVELOPMENT BANK

1

The Islamic Development Bank

Recent years have seen a trend in the Islamic World towards the estabilishment of ordinary commercial banks and Development Banks on Islamic principles. A few such banks (which participate directly in trade and industry) have already been set up; there is one at Cairo, Khartoum, Kuwait and Dubai. The Islamic Development Bank was also set up at Jaddah in 1975, with 27 founder members and now has a present membership comprising 32 countries. It is an independent institution and is managed and run by its own Board of Governors and Executive Directors. (1) This bank differs in its principles and functioning from modern banks as can be seen from its preamble which defines it as: "An International Finantcial Institution concerned with development and social welfare which derives its principles and directives from Islamic Principles and ideals, and will be a practical expression of the unity and solidarity of the Muslim people."

Capital

Its authorised capital is 2,000 million Islamic Dinars and the subscribed capital is 750 million Islamic Dinars (approximately U.S. 875 million dollars) payable in five equal annual instalments in any freely convertible currency acceptable to the bank.

The bank can also accept deposits from individuals, organisations and Governments and can also set up Special Funds and manage Trust Funds.

Objectives

The main objectives of the bank are:—

1. To foster the well-being of the peoples in the member countries.
2. To achieve a harmonious and balanced development of member countries.
3. To achieve such development through mutual financial and economic co-operation among the member countries.

4. To promote and strengthen co-operation among the member states in the economic, social and other fields of activity.
5. To mobilise financial and other resources both from inside and outside the member states.
6. To promote domestic savings and investment and a greater flow of development funds into the member states. (Because the whole project is development, investment and welfare oriented).
7. To strengthen co-operation and also to promite foreign trade particularly in capital goods among member states.
8. To provide a transfer of technology and skill from its own member states and also to mobilise outside technical assistance for member states.
9. To co-ordinate the regional development financing activities and to help in bringing about harmony in the efforts of the various development financing agencies in the region. (1)

Functions

In view of the above objectives of the Development Bank, its main functions will be:–

1. To participate in equity capital of productive projects and enterprises.
2. To invest in economic and social infrastructure projects through participation or other financial arrangements.
3. To advance loans to the public and private sectors for productive projects, enterprises and programmes.
4. To assist in the promotion of foreign trade especially in capital goods.
5. To provide technical assistance to member states.
6. To extend training facilities for personnel employed in development activities.
7. To undertale research in order to enable the economic, financial and banking activities to conform to the Law of *Shariah*.
8. To conduct its operations in accordance with the principles of *Shariah*.
9. To undertake any activities which may advance its purposes.
10. To co-operate with all bodies, institutions and organisations having similar purposes, in pursuance of international economic co-operation.
11. Unlike modern development banks, the Islamic Development Bank will

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1. Paper read by Dr. Ahmad Mohamed Ali, President Islamic Development Bank, at the International Economic Conference, London, July 1977.

accept deposits from the public, individuals, institutions or Government.

Difficulties

The bank is entering into a new world of its own, with a completely different set of objectives and functions. Because it has no ready-made model to follow, the bank will have to make its own way, formulate its own policy and principles, and build its own structure and organisation. However, in the light of its own objectives and principles, it can benefit from the organisational and structural advances of the modern banking system without infringing the Law of *Shariah* and build up a progressive banking structure capable of meeting the multifarious needs of its Islamic member states.

In the case of Islamic Development Bank one should not unduly worry about the absence of income based on a fixed rate of interst nor should one regard it as a 'buit-in margin of profitability', (1) because when one door of 'false profitability' is closed, Allah will open a hundered and one other doors of real earnings and profitability for His servants. One should honestly and sincerely try to follow the Divine Guidance in every sphere of life, without ever doubting one's immediate as well as 'ultimate' success. Once our economy is ridden of the evil of interst, it will prosper more rapidly than the interest-ridden economies of the Western world. Insha-Allah after a short time any initial difficulties experienced by the bank will be over and it will soon find itself on the road to success.

Modern financial institutions have utterly failed to provide any satisfactory solution to the problems facing the world. Rising inflation, recessions, unemployment, stagnation in business and foreign trade, concentration of economic power – all these evils have completely shattered the economies of the Western world. There is an opportunity for the Islamic banks to prove the effectiveness of interest-free banking to the West. It is the religious and moral duty of the Islamic world to work incessantly to organise and establish such 'equity banks' in various parts of the Islamic World and to prove their viability as profitable financial investment as well as development institutions. Once their viability as successful financial institution is established, the Islamic Development Bank can hopefully look forward to that day when it can present an effective panacea for the existing economic ills of the people and proudly

lead them out of this economic and financial destitution into the world of prosperity.

The absence of interest will undoubtedly provide a twofold stimulus to the bank's efforts to develop its financing: first, it will encourage the bank to use its funds more actively, productively and effectively to increase its finances; second, it will pressurise the bank to find new modes and uses of its funds.

Financial Operations

The bank has already started its work and has so far approved the financing of the following projects:– (1)

1. A loan of 6 million Islamic Dinars (approximately U.S. 7 million dollars) to the Song Loulou Hydro Electric Project in Camron as co-financing.
2. Equity participation by acquiring 400,000 shares of the value of 7.5 million Islamic Dinars (approximately U.S. 9 million dollars) in the Jordan Petroleum Refining Extension project.
3. Joint participation in Cotton Textile Mill in Sudan worth 2 million Islamic Dinars (approximately U.S. 2.5 million dollars).
4. A loan of 6.5 million Islamic Dinars (approximately U.S. 7.5 million dollars) to the Hargeisa Boram Project in Somalia as co-financing.
5. A loan of 6 million Islamic Dinars (approximately U.S. 7 million dollars) in the Kurvitola International Airport project, Dacca, Bangladesh as co-financing.

Priority

The bank will provide finance and give priority to various projects on the following basis:–

1. Technically sound and financially and economically viable.
2. Countries which are least developed economically.
3. Countries which have the largest commitment to economic development as reflected in their resource mobilisation effort, development programmes and the orientation of their economic and financial policies.

4. countries which demonstrate clear efforts towards self-help and have strong social orientation.
5. To all sub-regional and regional projects, enterprises and to those projects which promote complementary policy in the economies of member states.

The most important and essential requirements for the financing of a project by the Islamic Development Bank are safety, liquidity and a return based on performance. Given these requirements, the bank will also be willing to co-operate and offer short-term loans to trade, agriculture and industry from its surplus funds. (1) In the long-term projects, the bank will concentrate primarily on equity financing which has been grossly neglected by modern banking owing to its difficulties, complexities and the implications of involvement in ownership, management and supervision. The bank's participation in productive enterprises on prifit-sharing basis will then be another point of variation from the policy of modern banks.

Field Operation (1)

The bank will operate in the following three areas:–
1. Equity Finance.
2. Participation in productive enterprises on profitsharing basis.
3. Interest-free loans for infrastructure project.

Main Characteristcs (2)

1. The bank's operations will combine both investment and development, an innovation in accordance with the Islamic principles of solidarity and in keeping with the needs of the Muslims countries, demanding co-operation between the rich and the poor nations.

2. The bank's operations will extend beyond the purely economic to the social areas, for it will finance projects for social and cultural benefit of the people.

3. The bank's functions are based on sound economic principles as well as on the moral and spiritual values of Islam. It has declared the realisation of the

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2. Dr. Tawfiq Muhammad Al-Shawi, paper read at the First International Conference on Islamic Economics, Mecca, 1976.

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Housing development corporations can be established to provide long-term loans to individuals for building houses on the same principle. Co-operative banking can be organised to help consumers as well as producers in urban and rural areas. A net-work of co-operative societies up and down the country can meet most of the needs of the people, especially in the low-earning group, without involving any element of interest.

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